The New York Certified Public Accountant

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BOOK REVIEWS

Public Utility Accounting

By J. Rhoads Foster and Bernard S. Rodey, Jr. PRENTICE-HALL, INC., New York, N. Y., 1951. Pages: xxii + 690; $10.00.

This volume fills the void which has long existed for a complete, up-to-date treatise on public utility accounting practices and procedures. Its twenty-nine lucid chapters, which are written in a practical rather than theoretical vein, cover every phase of public utility accounting. While the book is of primary interest to public utility accountants, there are interspersed throughout, basic accounting concepts which are equally well adapted to non-utility enterprises, and which should also attract the interest of all students of accounting. The book is interestingly written, and will no doubt become the "bible" of public utility accounting.

The initial chapters explain the unique characteristics of the public utility industry and trace the development and growth of the industry and the concurrent development of adequate accounting records, from its feeble beginnings to the present Uniform Systems of Accounts under which practically all regulated utilities now operate. The importance of accounting as an instrument of regulatory control is emphasized.

The basic books, records and accounts of an average utility company are described in considerable detail, with several chapters devoted to cash transactions and accounts payable routine.

Five chapters are devoted to Utility Plant. The growth of the "Original Cost" philosophy is traced from its inauguration in 1931 to the present time, and the operation of and necessity for Continuing Property Records is explained. A typical work-order system for recording additions to or retirements of plant items is described in detail. The manner of treating indirect construction costs is also set forth. Two full chapters are devoted to definitions and principles of depreciation and amortization.

Other items to which chapters are devoted are materials and supplies, payroll procedure, taxes, customers' accounting, budgetary control, and internal auditing.

Of interest to all accountants is the chapter on preservation and destruction of corporate records.

A topical index is provided at the end of the book, which enables the reader to find the subject matter in which he is interested.

F. J. SERBEK

New York, N. Y.

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PERSONNEL AND BUSINESS OPPORTUNITIES

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BOOK REVIEWS

(Continued from page 660)

The Successful Practice of Accountancy

By Paul E. Bacas. PRENTICE-HALL, INC., New York, N. Y., 1951. Pages: xix + 458; $5.35.

A new and entirely different book has been added to accounting literature. Prof. Bacas has filled a gap which should be of considerable help to the accounting practitioners, both new and old. His book, dealing with the administration and conduct of an accountancy practice as distinguished from accounting and auditing procedural techniques is written in a clear, concise and easy-to-read style.

The book is divided into four sections as follows:

1. The practice of accountancy.
   Here the author briefly reviews the historical development of accountancy practice and the underlying requisites and rewards of the practicing accountant.

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2. Hints on entering the practice of accountancy.

   This section covers the details of selecting a location, opening an office, and how to obtain and hold clients, and develop the practice.

3. The accountant and his practice.

   A very practical discussion dealing with client conferences, fee determination, staff development, office organization and personnel policies, report preparation, and many other details necessary in the conduct of an accounting practice.

4. Specialization—legal and ethical questions—The C.P.A. examination.

   A review of the reasons for, and various types of specialized work; a discussion of professional ethics, legal liability of accountants and the C.P.A. examinations.

This book is recommended for every accounants' library. For the practitioner it presents a fresh viewpoint with many valuable hints and ideas. For the student and beginner, it presents succintly the many administrative problems of running an accountancy practice which are not in the academic and professional curricula.

H. D. Klein

New York, N. Y.

Comprehensive Accounting Problems—Volumes I and II

By Homer St. Clair Pace and Edward J. Koestler. Pace & Pace, New York, N. Y., 1951. Mimeo, 8½ x 11 inches, in four-post binders. Price: $5.00 each volume, plus postage.

In this two-volume work, supplemented by additional questions and problems in separate volumes, the authors have endeavored to provide a comprehensive review of basic accounting principles and techniques. Each of the forty-eight chapters, into which the text is divided, comprises the statement of a proposition (a problem similar to that which might appear on the C. P. A. Practical Accounting Examination), a discussion of the accounting principles underlying the situation, and the solution of the problem presented. The topics covered include preparation of statements, partnership accounting, actuarial mathematics, application of funds statement, mergers and consolidations, parent company and subsidiary accounting, private ledger, branch accounting, computation of inventory by retail and gross profit percentage methods, consignments, instalment sales, cost accounting, municipal and institutional accounting, average due date, fire loss, budgets, statement of affairs, brokerage accounting, real estate and construction accounting, break-even computations, syndicate transactions, and estate accounting.

For the student or practitioner with a sound accounting background, the text accomplishes its objective. The solutions presented are explained in careful detail and, except for some minor variations, follow standard form and procedures. Commendably, the authors have incorporated in their discussion, whenever applicable, the statements of principle propounded by the Accounting Research Bulletins of the American Institute of Accountants. In addition, the supplementary questions and problems are admirably suited as homework material for classroom use.

On the other hand, the sequence followed in each chapter of (1) stating the proposition, (2) discussing the topic in general, and (3) solving the proposition, produces two noticeable defects. First, since the background material is intended to cover the over-all topic in each case, the discussion necessarily becomes rather lengthy with the result that the reader, in view of this digression, is likely to forget the details of the problem at hand. Secondly, since each chapter is treated as an autonomous unit and is not related to the material in any other, where topics such as cost accounting and parent company accounting are involved in more than one chapter, the discussion in step (2) tends to become repetitious. The simple expedient of reversing steps (1) and (2), in conjunction with the presentation of a single coordinated review of basic principles in those topics where more than one chapter is involved, would enhance considerably the effectiveness of the work.

In addition, the material devoted to the actuarial accumulation of a sinking fund and the computation of a bond's "price to yield" appears to be of little value inasmuch as these topics are seldom found either in ordinary practice or on the C. P. A. Examination. It is the opinion of the reviewer that the additional space afforded by the elimination of these chapters, as well as the duplicate material referred to previously, might well be utilized in providing more complete illustrative problems for consignment accounting, retail inventory computations, and process costs, as well as additional chapters dealing with receivership entries, statement of realization and liquidation, statement of variation in profits, anaylsis of financial statements, mutual stockholdings, and stock rights.

In conclusion, the text merits praise as a good over-all review of basic theory and practice which, while it might be modified along the lines indicated above, constitutes a valauble addition to current literature in the field.

Irving J. Chaykin

The City College of New York

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

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The New Truck Mileage Tax

By ELLIS T. RIKER

The new Truck Mileage Tax Law, effective October 1, 1951, imposes important record-keeping requirements upon the members of this industry, with corollary implications for their accountants. This paper contains a careful analysis of some of the major problems raised by the new law.

I AM certain that you accountants have a general knowledge of this new law. The Tax Commission has publicized its provisions in the daily press and in the trade press. We have distributed informational booklets, forms and instructions, and we have held informational meetings from one end of the State to the other.

ELLIS T. RIKER was graduated from Manhattan College with the degrees of B.S. in Engineering and Industrial Engineer. He subsequently earned the degree of M.A. in Public Administration at New York University.

Mr. Riker has had 15 years of experience in office methods and procedures with various administrative bureaus of the State of New York. At present, he is Principal Examiner of Methods and Procedures in the New York State Department of Taxation and Finance.

This paper was the subject of an address by Mr. Riker at a technical meeting of the Society held on September 13, 1951, at the Engineering Auditorium, under the auspices of the Committee on State Taxation.

It is thought, however, that it may be helpful to review the fundamental requirements of this statute. Affected by the law is every motor vehicle, or combination of vehicles, which has a maximum gross weight over 18,000 pounds. Maximum gross weight means the weight of the vehicle plus the weight of the heaviest load it may carry. Maximum gross weight, of course, cannot be less than the manufacturer's rated capacity.

Generally speaking, there are two basic requirements: First, every vehicle subject to this law must have a highway use permit and plate in order to use legally the streets and highways of New York State on and after October 1. If a carrier has tractors and trailers, that means a separate permit for each tractor and each trailer.

Secondly, each affected vehicle is subject to a mileage tax based on maximum gross weight (or unladen weight if empty) and the number of miles operated in New York. Each carrier will have to file monthly mileage tax returns (Form TMT 3)—due the 20th

of the month for operations during the preceding month—and pay the mileage tax when the return is filed.

Commission's Policy

When we started out several weeks ago to meet with truckers in communities across the State, for the purpose of explaining the application of the law, we tried to define the administrative policy of the Tax Commission.

We said then, and I should like to emphasize again, that the Commission's basic policy is that the law will be fully enforced. However, it will be the constant aim of the Tax Commission to make taxpayer compliance just as easy and convenient as possible; to apply the statute reasonably, and to do whatever we can to hold to a minimum the cost of compliance.

There are, in fact, numerous tangible evidences of this policy of the Commission to assist the industry. For instance:

We have, from the very beginning, been in constant consultation with representatives of the industry so that we know and understand the problems, and have made every effort to gear administrative planning to the practices of the industry, consistent with mandates of the statute.

We have done our utmost, through meetings and through publications, to explain the requirements in the greatest detail.

We have made our various forms and instructions as simple as possible under the law, and are providing assistance in the field.

We have, in our regulations now in preparation, made every effort to liberalize requirements—again, consistent with the mandates of the statute.

And while the law permits the Tax Commission to require carriers to submit financial statements and file surety bonds, the Commission is not imposing these requirements in the first instance.

We can help the carriers (common, contract and private) meet the requirements—and you accountants can help your clients, particularly the private carriers, in meeting these requirements. But, in the last analysis, the responsibility for compliance is the truck owner or lessee whether he works for hire or merely transports his own products.

Now, perhaps you would like to have me review some of the provisions of the law which are least understood—and some of the troublesome situations which we hope to resolve in our regulations.

Maximum Gross Weight

First, there is the matter of maximum gross weight, which has given rise to a good deal of misunderstanding. Remember that this is not a ton-mile tax. In a ton-mile tax, the rate of tax depends on the actual weight of the vehicle and load on any particular trip. But under this truck mileage tax, regardless of the actual weight of your load, the rate of tax always depends on the maximum gross weight—with one exception. If the vehicle is being operated without any load whatsoever, its empty mileage is taxed on a basis of the unladen weight of the vehicle. If that unladen weight is less than 18,000 pounds, the empty mileage is not taxable.

As you know, the carrier sets forth the maximum gross weight of each vehicle in his application for permits (Form TMT 1). In determining the maximum gross weight of a vehicle, you take the unladen weight and add to it the weight of the heaviest load it may carry, remembering that in any event the maximum gross weight cannot be less than the manufacturer's rated capacity.

You must remember, too, that the maximum gross weight of a vehicle is a constant factor. It is not altered by the fact that on one occasion you may carry heavy metal and on the next a light, bulky cargo. Nor is it altered by deliveries along the route which decrease the load. Even though the vehicle may never operate at the manufacturer's rated capacity, the maximum

gross weight cannot be less than the rated capacity under this law.

On the other hand, this law does not prevent establishing the maximum gross weight of a vehicle at a level higher than the manufacturer's rated capacity, if the heaviest load the vehicle carries exceeds rated capacity. But bear in mind the legal weight limits under the Vehicle and Traffic Law. Issuance of a permit for a vehicle with a maximum gross weight in excess of the legal limits under the Vehicle and Traffic Law does not authorize the carrier to operate in violation of the Vehicle and Traffic Law.

If the manufacturer's rated capacity of a vehicle is higher than the legal limits for that vehicle under the Vehicle and Traffic Law, its maximum gross weight would be the legal limit. This is the only instance in which maximum gross weight of a vehicle may be fixed at a point less than the rated capacity.

Once the carrier has obtained a permit for a vehicle, indicating its maximum gross weight, this weight will govern the tax on its operations, except that as previously pointed out, unladen weight controls for mileage operated empty. Any changes in information reported on the permit application must be reported to us immediately. Thus, if unladen or maximum gross weight of a vehicle is altered by structural changes, this must be reported to us. When necessary, we will issue an amended permit to reflect changes.

In any event, it is well to bear in mind that permits and plates are not transferable. They may be used only by the carrier to whom they are issued, except where a vehicle is leased for thirty days or less. Under no circumstance may a permit and plate be used on any vehicle other than the one for which the permit was issued.

Leasing of Vehicles

The leasing of vehicles, a practice which is common in the trucking industry, posed numerous problems as to who should obtain the permits and pay the tax. In our regulations, we have simplified as much as possible the tax and permit procedures as applied to leased vehicles.

Where a vehicle is leased for 30 days or less, it will not be necessary for the lessee to obtain a permit and plate. The lessee in these short-term leases may operate the vehicle on the permit and plate of the owner.

However, in cases where the lease covers a period of more than 30 days, the lessee must obtain a permit and plate, even though the owner already has a permit for the vehicle. The lessee's permit and plate are valid only during the term of the lease and thereafter have to be surrendered within five days, unless the lease is immediately renewed or extended and the same lessee continues to operate the vehicle. While a vehicle is being operated under a lessee's permit, the owner may retain possession of his permit and plate for the vehicle or he may surrender them to the Tax Commission. If he keeps the permit and plate, he must report monthly on the vehicle, indicating who is using it.

Now as to payment of the tax on leased vehicles. Both owner and lessee are responsible for payment of the tax. Either may pay it. If the lessee pays the tax, the owner need only report on a separate form (Form TMT-4), filed with his tax return, the name and address of the lessee. In this case, the lessee would include the vehicle in his tax return. If the owner pays the tax, the vehicle is included in the owner's return on Form TMT-3.

Zone Exemptions

Zone exemptions in the law have also raised many questions, some of them resolved by rulings from the State Attorney General. As you know, a vehicle is exempt from the mileage tax (even though it must have a permit and plate) if it is operated exclusively within a Public Service Commercial Zone, a city or village.

The word "exclusively" is the key

word in the exemption. What happens if a vehicle, normally operated within a zone, crosses the zone line? The Attorney General has ruled that if a vehicle operates outside its zone at any time during a calendar month, all of its operations in New York State during that month—both within and without the zone—become subject to the tax.

Then there is the situation where a vehicle enters New York State from outside the State but confines its operations to a zone abutting the State line. For example, a vehicle comes into the New York City zone from New Jersey. The mileage is tax exempt if the operation is limited to the single zone.

Likewise, in the case of a vehicle which operates exclusively within a single zone, except for operations outside the State, the mileage is tax exempt.

What happens when a vehicle enters a zone and its cargo is transferred to another vehicle, this second vehicle being operated exclusively within a zone? The mileage of the first vehicle is taxable. That of the second vehicle, which does not leave the zone, is exempt from tax.

These same general principles, applying to zone operations, have application also to operation exclusively within the incorporated limits of a city or village. It should be noted, however, that operations between contiguous cities which are not in the same PSC zone are subject to the tax.

Record-Keeping Requirements

The record-keeping requirements under this statute are, of course, of particular interest to you accountants. These requirements have been developed in consultation with the industry, trucking associations and individual carriers, common, contract and private. Every effort has been made to set up the record-keeping requirements in accordance with the present accounting and record-keeping practices of the various types of truck users.

The prime record-keeping requirement is a daily record of vehicle operation which is a manifest or trip record.

Every carrier who operates a motor vehicle in this State, which is subject to the tax under Article 21, must maintain an accurate daily record of all operations of such vehicle in this State. The daily record of operations is not required for those vehicles where it is known that they will be operated throughout a calendar month exclusively within a Public Service commercial zone or in a city or village.

This daily record of operations shall be in the form of a manifest or trip record. The record must contain the following information:

1. The date of each trip.
2. The permit and vehicle numbers.
3. The point of origin and destination for each trip.
4. The number of round trips each day.
5. The number of miles travelled laden.
6. The number of miles travelled empty.
7. The name of the owner if operating a leased or interchanged vehicle.

The daily manifest or trip record shall show each trip for the day. If the daily manifest is used to record the operations of more than one vehicle, a monthly summary shall be prepared for each vehicle or vehicular unit at the end of each month.

The particular form of daily manifest or trip record is not prescribed. Any form used by the carrier will be acceptable to the Tax Commission providing it reflects the information set forth previously.

Every carrier who operates a motor vehicle in this State, including motor vehicles which are operated exclusively within a Public Service commercial zone or within the incorporated limits of a city or village, shall maintain such records as bills of lading, waybills, freight bills, invoices, shipping orders, dispatch sheets, records of vehicles leased, interchanged or hired, drivers' daily logs or trip sheets which are necessary to substantiate the operations of the vehicle. Where it is necessary that daily manifests be maintained, bills of

lading, waybills, freight bills, invoices or shipping orders should be cross-referenced to the particular manifest to which they apply, or they should be filed in such a manner that they will be available upon request at the time of audit in conjunction with the appropriate manifests.

Any other records ordinarily used by the carrier in conducting his business will be accceptable to the Tax Commission providing such records reflect the (required) information to substantiate the operations of the vehicle.

In addition, speedometer readings, fuel consumption records, maps, mileage or tariff schedules or record of mileage used for billing purposes and used to compute the taxable mileage shall be kept available. The mileage shown in the daily manifest or trip records for each vehicle shall be totaled at the end of each month and entered on the monthly tax return. (Form TMT-3)

All the records required under this Article and any other records used by the carrier to determine the tax liability shall be kept in this State unless the State Tax Commission consents to their removal. Permission for removal may be granted provided the carrier agrees to produce his pertinent records within this State upon request for audit or agrees to pay traveling expenses and subsistence allowance incurred as a result of making the audit without the State. All tax reports and all such records shall be preserved for a period of five years and shall be open for inspection and audit upon request.

The booklet, "Record Requirements for the Truck Mileage Tax", which has been prepared primarily for the smaller carriers who do not presently keep records of any kind, has been distributed to you. This booklet outlines the method of preparation of the Application for Permits and the Permits themselves, illustrates three different types of manifests or trip records which can be used, shows the method of preparation of the Truck Mileage Tax Return (Form TMT-3) and carries through these forms sample entries for a number of vehicles and for different types of operations. This booklet also shows the optional reporting method.

Optional Reporting Method

I should like to make reference, just briefly, to this optional reporting method. In filing the monthly tax return, (Form TMT-3) the carrier may—at his own option—employ either of two methods if he operates more than one tractor or trailer which are used interchangeably.

A strict, inflexible interpretation of the law would require that you compute the tax separately on the mileage of each separate tractor-trailer combination used during the month for which you are reporting. It was obvious that this would impose a severe problem of reporting on those carriers who operate large numbers of tractors and trailers interchangeably. Therefore, after consultation with the industry—and on the industry's own recommendation — we have provided an alternate, simplified method of reporting which is available to any carrier.

Under this alternate method, the tax is based on trailer mileage. The carrier electing this method does not report on each individual combination used. Instead, he reports for each trailer, for tax rate purposes using as maximum gross weight the maximum gross weight of the trailer plus the unladen weight of the heaviest tractor owned by or leased to the carrier during the reported month.

For many carriers, this will be a tremendous timesaver. And, frankly, it will result in a simplified, less cumbersome audit for us. But remember that its use is entirely up to each individual carrier. The cost of maintaining the records on individual combinations should be determined and compared with what additional tax might be involved by using the optional method before selecting or recommending the reporting method.

Whichever method is used, returns must be supportable by complete records available to the Tax Commission for audit. That means a daily record of all operations, showing the date of each trip, permit and vehicle numbers, points of origin and destination for each trip, number of round trips each day, number of miles travelled laden, number of miles travelled unladen and the name of the owner if the vehicle is leased or interchanged.

You realize, of course, that there will be periodic audit of these supporting records in the field, as well as regular audit of returns in our offices. And you are aware that weighing stations, supplemented by mobile weighing units, will be operated throughout the State by the Department of Public Works to verify the maximum gross weight and unladen weight of vehicles subject to the law.

In connection with these weighing units, it is pointed out that operation with a weight in excess of the maximum gross weight set forth in a permit for that vehicle is one of the grounds for suspension or revocation of the permit and plate. Furthermore, if the actual weight of a loaded vehicle exceeds the maximum gross weight in its permit, the tax must be computed at the rate which corresponds to the actual weight. In other words, operating in excess of the indicated maximum gross weight will result in the imposition of a higher tax rate—if it puts the vehicle in a higher tax bracket.

Other Grounds for Suspensions

I have indicated one ground for suspension or revocation of a permit and plate — exceeding indicated maximum gross weight. Perhaps reference should be made to other grounds for cancellation of permits, such as:

Failure to file a return or pay the tax, filing a false or fraudulent permit application or tax return, operating without a permit and plate on the vehicle, failure to produce records for audit, an incorrect statement of maximum gross weight in the permit, using a permit or plate on a vehicle other than the one for which it was issued, failure to surrender permits and plates upon request, or avoidance or failure to comply with weighing requirements.

And remember that if one permit and plate is suspended or revoked, all of the permits and plates of the carrier are automatically subject to the same action, unless otherwise specified by the Commission. In addition, the vehicle or vehicles are liable to loss of the privilege of obtaining motor vehicle registration plates from the Bureau of Motor Vehicles.

Granted that these are strong provisions—that this law really has teeth in it. But the penalty provisions are primarily for the protection of the honest, law-abiding taxpayer who is prepared to comply—and who is the loser if some less scrupulous operator attempts to evade the tax. The lawful, legitimate business man has nothing to fear in this statute. The tax evader will face the hard going that he deserves to face.

Standard Cost Accounting for the Small Manufacturer

By J. S. Gustafson, C.P.A.

Few accountants realize that the principles of standard cost accounting are particularly adaptable to simplified procedures for the smallest manufacturing company, with few exceptions. In this paper the author illustrates in detail the approach to the design and installation of a simple standard cost accounting system for a small manufacturing operation. Accountants serving the smaller-sized client should derive many practical, helpful ideas from it.

Control is now generally recognized as the most important purpose of cost accounting. It is exercised along two principal lines: Control of costs and expenses through timely reporting of unfavorable conditions, and control of income through the direction of sales efforts toward the more profitable items in the line. With the advent of price stabilization, these considerations become increasingly important.

J. S. Gustafson, C.P.A., (Illinois), is the Manager of the Chicago Special Services Department, of Touche, Niven, Bailey & Smart, C.P.A's. Prior thereto he was a systems specialist with one of its predecessor firms, following fours years of service as a Cost Inspector, U.S.N., in the Ninth Naval District.

Mr. Gustafson was graduated from Northwestern University and, also, pursued post-graduate work in accounting and engineering. He was formerly an instructor in accounting at Loyola University.

Mr. Gustafson is a member of the American Institute of Accountants, the Illinois Society of C.P.A's., the American Accounting Association, the National Association of Cost Accountants, and the Society for the Advancement of Management.

This paper is based upon an address made at the Evansville, Indiana, Chapter of the N.A.C.A.

It is particularly because of its remarkable control features that a system employing cost standards is preferable in all but a few very special situations. But a standard cost accounting system also has the extremely important advantage of economy of operation. This philosophy of cost accounting has been adopted widely by all types and sizes of businesses in recent years. However, if there is any one stronghold of resistance remaining, it is concentrated among the small businessmen who, through a lack of understanding, view cost standards as an expensive tool adaptable only to a manufacturing operation large enough to support elaborate cost accounting, time study and production engineering departments. This certainly is not the case. The principles of standard cost accounting are considerably more flexible in mode of application than any other type of cost accounting system and are particularly adaptable to simplified procedures for the smallest manufacturing company.

Advantages of Cost Standards

Before considering the detailed procedures, it would be well to examine some of the major advantages in the use of cost standards over the so-called actual cost types of systems.

Availability of Current Unit Costs

Current unit costs are always readily

available through the use of the standard cost summaries. In a relatively simple product, current or even anticipated material prices can be substituted for the material standards appearing in the summary. In a complex product, the recent material price variances experience can be applied to the standards on a percentage basis to obtain a quick approximation of current material cost. Likewise, recent labor and burden variances can be applied to labor and burden standards to reflect the current costs of these elements.

Under other types of systems, unit costs are only as current as the most recent production run. And all the voluminous clerical work of posting time reports and material requisitions must be completed before a unit cost can be calculated. But the real problem exists in the selection of a representative unit cost when, as is usually the case, the unit cost fluctuates widely from one production run to another. Material may have been purchased at various prices or labor costs may vary because of performance, or machine trouble, or hard castings, or any number of causes. Abnormalities can be isolated only by detailed analysis, if at all, but even then there is the problem of what to do about them. Certainly they should not be charged wholly against the particular production run on which they just happened to have occurred, yet some portion must be borne by all production if the costs of such extraordinary but not unusual conditions are to be recovered.

Effective Control of Costs

In the matter of control of costs, the standard cost accounting system stands almost alone. In addition to answering the question, "What does the product cost?" it also shows what the product *should* cost and localizes the causes of excesses. This instrument of control begins with the monthly statements which not only show management the results of operations but highlight the areas in which cost control should be improved. Through an analysis of variances, the cause of any serious condition may be determined. Then, if necessary, weekly or even daily reports of such conditions can be instituted to assist management in correcting the deficiency. But such detailed and frequent reports are prepared only when and as long as they are required, concentrating efforts on the "trouble spots" and permitting normal operations to be accounted for at a minimum clerical expense.

What control is offered by other types of systems? Attempts may be made to compare the unit costs of the same item under several different production runs, but only in the most simple of operations is this very fruitful. It may disclose that unit labor costs have increased, but it seldom indicates why. Even an apparent decrease in unit labor costs is no assurance that they are not still grossly in excess of the best performance attainable. And the greatest deficiency is that usually no costs can be computed for comparison until the production order is closed out. By that time the conditions which cause excessive costs may be months old. The opportunity to recognize and correct a serious condition at the time it occurs just is not there.

Early Monthly Statements

A further important advantage of a standard cost accounting system is the ease and speed with which the books can be closed and monthly statements prepared. All material, direct labor, and burden charges to inventories throughout the month have been made at standard. There remains only the task of applying standards to the items shipped to compile the cost of products sold. There is never any doubt as to the selection of costs applicable to any unit shipped.

Under other types of systems, no shipments can be costed until they are identified with a particular production order and the unit cost under the job order is computed. But the unit cost cannot be computed until the job is closed out, and the job cannot be closed out until all time charges and material

requisitions have been priced, extended and posted. If component parts have been used in higher assemblies before production is complete under the part orders, then a real problem exists as to what costs to use. An instance of this difficulty comes to mind where a company formerly had used estimates for this purpose, but experienced such serious differences when the production orders were ultimately closed out that they adopted the policy this year of deferring the closing of assembly orders until all related sub-assembly and part orders were closed. At the end of May they were still exerting every effort to complete their January operating statements! This is, of course, an extreme case in which the weaknesses of a job order cost system are magnified by a very complex line of products, but it is indicative of the problems at month end which are always experienced to a greater or lesser degree in conection with this type of cost accounting.

Clerical Economies

Now, where are the economy features of a standard cost accounting system? Probably the greatest saving is that a perpetual inventory record of quantities and costs is not required inasmuch as inventories are always stated at standard. Under other systems, complete and continual identity of costs is necessary from the time they are initially incurred until the time they are finally transferred to cost of goods sold. This means records of all raw materials, records of all purchased and manufactured parts, records of all jobs in process, and records of all finished assemblies. If there is one thing an "actual cost" system does produce, it is records.

Savings are also realized under a standard cost accounting system in permitting the elimination of labor time tickets and productive material requisitions, if so desired. This not only results in a substantial reduction of clerical work in the office, but is always hailed with great enthusiasm by plant personnel. A complete standard cost accounting system can be operated with no more information from the plant than reports of production, scrap, and rework. Under some procedures, even the reporting of rework is not essential.

Situations for Which Cost Standards Are Unsuited

It was mentioned earlier that only in a very few cases are standards unsuited for cost accounting purposes. One of these cases is production under cost or cost-plus-fixed-fee contracts, although standards can be adapted to this production and should be if it represents only a small portion of a company's operations. Standards are entirely suitable in accounting for production under target price contracts or contracts involving price redetermination at one or more points during the period of production.

Other cases in which cost standards are not entirely suitable for cost accounting are so-called job shops which produce individual items or very short runs entirely to a customer's specifications. Even in these cases, material and burden might advisably be accounted for on the basis of standards. Moreover, even though the end products produced to customers' specifications might vary widely in appearance, a similarity in parts and in operations might permit the use of standards. A recent experience with a company engaged in the manufacture of industrial furnaces and boilers is an example of this situation. Their products were engineered and no two were the same. However, investigation revealed that many sub-assemblies were common to numerous furnaces and boilers, and even many of the assembly operations were similar. After some study, it was determined that only about five to ten per cent of the labor performed on any furnace or boiler was wholly peculiar to the particular customer's requirements, and that all

the remainder could be reduced to a definite set of standards. It was a simple matter then to have an engineer estimate the five to ten per cent non-standard operations at the time a job was bid on, and to use this estimate as the standard in accounting for subsequent production.

Detailed Standard Cost Procedures

Now let us consider some of the detailed procedures which might be adopted in designing a standard cost accounting system for the small manufacturer. Only a few typical ones will be discussed because the possible methods and their applications are legion. It is the selection and appropriate application of these methods in a combination which is most suitable to a particular company's operations that mean the difference between a good or a poor system. Because the operations of no two companies are exactly alike, there probably are no two cost accounting systems exactly alike—or at least there shouldn't be. Consequently, it is only hoped that the procedures discussed here will serve as illustrations of the approaches which might be taken in designing simple cost accounting systems for small manufacturing operations.

Integration With General Accounting System

First, a few words on the question, should the cost accounting system be integrated with the general records of account? Whatever arguments are forwarded for operating a cost accounting system statistically, they invariably appear to be more than offset by the attendant disadvantages. Unless all of the costs and expenses of a particular operation are accounted for, a cost accounting system is not being operated, but merely cost sampling procedures, and the results may be quite unreliable. If all of the costs and expenses are encompassed, no extra work is involved in reflecting the results directly in the books of account and no better assurance can be had that all recorded items have been considered in the cost computations. For this reason, it is strongly advocated that the cost accounting procedures be integrated with the general accounting records.

Material Cost Standards

Let us take up the problem of accounting for material. As in the case of each cost element, two types of standards are required: price and quantity.

Material Price Standards

The easiest way to establish the price standard for material is to let the first purchase of each item determine the standard, except, of course, that any emergency purchases at unusual prices should be disregarded for this purpose. Such standards are useless in measuring the effectiveness of the purchasing and planning activities, but they will serve satisfactorily for bookkeeping convenience and for disclosing subsequent material price trends. At the time each unit price standard is set, a material unit standard card is made out showing the specifications, unit of measurement, and unit price. These material price standards can be re-established on the same basis each year, or they can be used indefinitely, or at least until they get too far out of line with current prices. It is probably advisable to revise standards annually, but where so many products are involved that this becomes too arduous a task, some companies prefer to revise standards only very infrequently. In such cases the price standard is considered to be in the nature of a "base period" cost, and the price variance an index of change since the base period.

A superior method of establishing material price standards is (1) to estimate roughly the quantity of each type of material which will be required,

(2) to determine the most economical quantity in which it is practical to purchase each, considering storage facility limitations and desired turnover, (3) to select the supplier which can meet specifications and delivery requirements at the lowest price, and (4) to establish the price standard on the basis of that supplier's price list. Some follow the practice of selecting the current price for the standard. Others attempt to project the market trend over the ensuing year to minimize the cumulative material price variance. Both of these are acceptable methods and each represents a particular philosophy in the use of cost standards.

Material Quantity Standards

The quantity standard for material means, of course, the amount of a particular type of material which should be required to produce a particular product. The ideal source of this information is the engineering bill of material, showing the type, specifications, and dimensions of raw material required and a description of each manufactured or purchased part. The quantity or dimensions of the raw material should include an allowance for *unavoidable* waste or scrap as, for example, the offal produced when a circular part is blanked out of steel strip. However, no provision for scrap which reasonably could be avoided should be included in the standard.

This method is fine where current engineering bills of material are available, but in many small companies very little is available in the way of recorded technical data. The burden of compiling it, if it is to be compiled, sometimes rests wholly on the cost accountant. How does he go about it? First, it is essential that he have a suitable bill of material form so that the data which he develops can be filed and maintained systematically and uniformly. The arrangement of the form should be determined by the nature of the company's productive operations, particularly as to the number of parts and types of raw material involved in the product and as to the number of *levels* of subassemblies. In some cases the bill of material and the labor operations sheet can be combined on the same form; this is a great convenience where it is feasible, but results in a sorry mess where the circumstances are not appropriate. Therefore, the form should be designed with a great deal of care.

The second step in compiling the bill of material data should be the development of a logical plan of sequence. For example, if the company manufactures a line of products on a substantially continuous production schedule, it might be advisable to complete one group of similar products before commencing another, and to begin cost accounting control for materials on a partial basis as soon as the first group is complete. Or, if there are numerous common materials, it might be advisable to attempt to complete a particular type of material "across the board" without regard to products. If the production of the company's products is not continuous, but various individual items are scheduled to be produced spasmodically as required by sales demand, it would probably be advisable to compile the bills of material first for the items most frequently produced and to develop the remainder only as they are scheduled for production after the system has been inaugurated.

The next step in compiling the bill of material data is to obtain the material specifications and quantities required for each product in the sequence decided upon. Where this is not readily available, the chances are that even an embryo engineering department does not exist, either because the company is too small or because its operations do not require full-time engineering services. Here is where any engineering background or shop experience which the cost accountant possesses is exceedingly valuable. Even though it is most important that he enlist all available assistance, his own understanding of production methods, blueprints, and raw material charac-

teristics facilitates and accelerates the process of compiling the data. In the absence of any written information, the preferable approach to obtaining the data is to observe the actual flow of production. Where production of each item is not continuous, disassembly of finished items may be resorted to in compiling the required engineering data. In such cases, reliance must be placed on the advice of experienced plant personnel as to the size and type of raw stock used in the manufacture of the parts. In medium-sized plants, the knowledge of the superintendent and foremen is usually helpful. In small plants, this type of information might be obtained directly from the productive employees or even from the company owner himself.

In the case of companies producing substantially to customers' specifications, the cost estimates made in preparation of the bid or price quotation might well supply the basis not only for the material standards, but for the labor standards as well. These are particularly suitable for short production runs or for initial temporary standards for longer production runs. Their continued use over a period of time should first result in testing and improving cost estimating procedures, which certainly are of the utmost importance in this type of business, but eventually in cost control as well. Under these circumstances, cost accounting procedures can be placed in operation almost at once.

Not infrequently, the first benefits to accrue from a standard cost accounting system are realized in connection with the preparation of the bills of material. One striking example of this comes to mind where the cost accountant had barely begun to compile the material quantity standards before he found that the purchasing agent was using obsolete specifications in ordering steel bar stock, the principal raw material, and that one in each ten units cut from the bars was scrapped because the bars were not in proper multiples of the units required. It is difficult to realize that a condition like this could exist, but it had existed without detection for more than two years, and the remarkable fact is that it is not uncommon.

Labor Cost Standards

The same two types of cost standards are also required for direct labor: price and quantity.

Labor Price Standards

The price standard is the normal labor rate. It is determined by the classification of productive employee normally required to perform each operation economically. The higher the degree of skill required, the higher the rate which usually must be paid. Practice of the company or job classification rates prescribed under its union contract will establish the standard. Where there is not a wide range of rates within a department or where the entire department works generally as a crew, an average departmental rate can be used to advantage in reducing the clerical work involved. Otherwise, normal individual rates should be used.

Labor Quantity Standards

The labor quantity standard presents substantially more difficulty. The quantity standard in the case of labor is the length of time it takes to perform each operation. The form on which these data are compiled is again an important consideration and warrants a good deal of thought. This form is usually called the "operations sheet" or the "routing sheet"; it contains a sufficiently detailed description of each operation in proper sequence, and frequently shows such additional information as department number, tool number, machine number, etc. As mentioned before, the operations sheet can be combined in a single form with the bill of material under appropriate circumstances.

Before any attempt can be made to establish labor standards, it is essential

that all operations on each part in each product be identified and recorded on the operations sheet. In the absence of orderly data prepared by a production engineering department, the cost accountant must again seek the information from whatever sources exist. As in the case of material, following the flow of production, particularly with the assistance of experienced plant personnel in developing uniform nomenclature for describing operations, is a good method of compiling operational data. In this connection, it is important that the cost accountant question whether the current methods and sequence are the ones ordinarily followed and which, therefore, should be accepted as prescribed standards until officially changed. Operations sheets for items which are not currently in production might be built up by discussions with plant personnel, particularly if a sample of the product can be disassembled and examined. But at best this method is not without risk of omitting operations, so that unless it would impose too great a burden at a later date, it would be preferable to defer the preparation of operations sheets for such products until the time they are actually in production.

We are now ready to approach the problem of establishing the time standard.

Ideally, of course, time standards should be based on time studies, standard data, or the new Methods Time Measurement which is receiving considerable acclaim. However, it is seldom advisable to attempt to obtain such refined time standards at the outset of a cost accounting installation in a small company. In the interest of initiating cost accounting coverage as soon as feasible and of minimizing the cost of the preparatory program, it is usually preferable to develop temporary labor time standards by some alternative method, postponing the adoption of more scientific methods until the complete system is operating smoothly and benefits are being realized therefrom. When this point is reached, if it appears advisable to undertake a time study program, it is certainly not essential that a full-time experienced time study engineer be employed for this purpose unless the operations of the company are extensive enough to justify such expense. The accountant or cost accountant can be trained to make acceptable time studies; these studies can then be made as a "fill-in" job, gradually substituting good, permanent standards for the temporary standards in use.

What, then, are some of the alternative methods of establishing temporary direct labor time standards? Past experience is helpful if the information is available, but usually where the company has operated without a cost accounting system in the past, labor and production reports are not available in a form which would permit computation of unit production time. If the company is converting from a job cost system to a standard cost system, then past experience frequently can be used. In such cases, it is usually preferable to select the shortest unit production time experienced rather than the average unless there is some evidence of incomplete or erroneous time reporting on the job. It would be rare that following such a policy would result in establishing standards which are too "tight."

In most cases, a combination of several methods of establishing labor time standards is employed. An operation or a series of operations in sequence may be clocked—that is, the elapsed time per unit determined without any study of the elements of the operation or weighting of the factors of skill, effort, fatigue, etc. To the unit time determined in such a manner must be added an arbitrary allowance for personal time. Data compiled in this manner do not compare with true time studies, but they might well be employed as temporary standards and they can be accumulated very quickly. Where a particular item is not in pro-

duction or a particular operation or group of operations on an item is not being performed, it is sometimes feasible to have the plant superintendent or a plant employee go through the motions of the operations several dozen times while he is being clocked. Again, a foreman's estimate may provide the basis for a temporary standard; in such cases, it is usually easier for him to estimate in terms of pieces per minute or per hour rather than in time per piece or per 100 pieces. The estimate can be converted readily to time per piece or per 100 pieces for convenience in cost accounting use. Another source of temporary time standards is machine cycle data in those instances of continuous runs where the machine rather than the operator sets the production pace. Still another source is published data for various types of operations. These data are especially useful, where appropriate, after testing a few to the plant's actual experience to develop an average percentage adjustment to apply to the published data to reflect the plant's own tempo of production.

As discussed in connection with material, where the company's production is primarily to customers' specifications, the cost estimates made for quotation purposes might well be employed as standards for labor as well as material. In such cases, the labor might be estimated in considerably larger segments than individual operations, but ordinarily this will serve the purpose just as well.

After the time standards have been established, they should be extended by the standard rates and the standard labor cost of each product compiled.

Manufacturing Expense Standards

As to factory expense, it also involves standards of quantity and price —quantity being the volume of direct labor anticipated for the ensuing year (since burden will ordinarily be applied on that basis) and price being the total of all indirect factory expenses which normally should be incurred at such a level of productive volume. Ideally, both of these standards should be based upon a budget originating outside the accounting department, but in the absence of a formal budgeting program the task of establishing the burden standards invariably falls to the accountant. While it is advisable to avoid burdening management with detailed considerations in connection with setting burden rates, the assistance of management should be enlisted in obtaining answers to such general questions as: Is any significant change in the volume of production anticipated? Are any changes in the nature of operations planned? Are any substantial expenditures for plant or equipment being contemplated? With this information and an analysis of prior period expenses, the accountant is in a position to establish satisfactory burden rates.

Single vs. Departmental Burden Rates

Considerable thought and study should precede the decision to use departmental burden rates or a single, plant-wide burden rate. If departmental rates do not vary widely, the use of an over-all rate is acceptable and desirable. However, if there is quite a range in departmental rates, the little additional clerical work involved in employing them is more than justified by the increased accuracy in results.

If a single, plant-wide rate is used, burden need not be posted at all to the standard cost summaries—it can be computed conveniently on the several month-end journal entries. But where departmental rates are used, it is necessary to compile the burden on the standard cost summaries.

Routine Operating Procedures

The first important consideration in designing the operating procedures of the cost accounting system is to arrange for reliable reporting of production,

scrap, and rework. Some possible sources of production counts are the individual operators, the foremen, or inspectors,—if the plant is large enough to have either—or the storekeepers. The type of system contemplated will determine the type of production data required. Direct labor and burden can be charged to the inventory accounts on the basis of individual operations, completed parts, completed sub-assemblies, or entire shipping units produced. It is particularly advisable in dealing with a small company to select the broadest basis feasible in order to minimize the volume of plant reports and the clerical work in the office. The degree of fluctuation of work in process and of stock-piling of parts and sub-assemblies will be the determining factors in the selection of a production reporting basis. Where the degree of fluctuation is not substantial, the selection of production counts of entire shipping units permits the elimination of all accounting reports required of most plant personnel except the daily attendance report.

Appropriate forms should be designed to facilitate the reporting of production, scrap, and rework. Scrap reports should provide for an exact identification of part, the quantity, and, if necessary, the last operation completed. Rework reports should provide for specific identification of part and operations, and for quantity reworked.

It is suggested that, for simplicity's sake, only two, or a maximum of three inventory accounts be maintained: Material, and labor and burden combined; or labor and burden individually. This is sometimes referred to as the "four wall" method. An exact analysis of inventories by status (raw, in process and finished) is not always sufficiently important to warrant the clerical expense of maintaining it. But even where it is, it might be advisable to add that refinement at a later date rather than complicate the initial procedures.

Shipments can be costed by applying the finished product standard costs to the individual items appearing on each invoice or by summarizing all like items shipped throughout the month and extending the total quantities by their respective standard costs. The former method tends to avoid a peak work load at month end and is particularly appropriate where the shipments are quite diversified. However, where numerous shipments of relatively few products are made, the latter method effects a substantial reduction of clerical effort.

As a minimum, variances should be analyzed for management by the elements of cost: Material, labor, and factory expense. A further refinement of analysis of material variance by price and usage, of labor variance by rate and performance, and of factory expense variance by volume and expenditures should be added whenever any of these reach serious proportions. Then, as the need arises, much finer analyses as to responsibility and causes can be prepared.

A Few Case Reports

In discussing the detailed procedures, although only a few of the numerous alternatives were mentioned, an attempt was made to indicate the most simple procedure in each instance, circumstances permitting. Each company has its own problems and its own peculiarities and, consequently, it is impossible to establish any rule of thumb to relate the expense of cost accounting to the volume of the business. But as indications of what can be accomplished, it might be of interest to mention several cases in which substantial cost accounting benefits have been realized at a minimum of expense. At one company doing a half a million dollars annual volume, a fully integrated cost accounting system is being operated by one individual who devotes approximately one-third of his time to cost accounting and cost estimating combined. In another company doing an annual volume of two million dol-

lars, but in a relatively simple processing business, the general accountant spends less than half of his time operating a very effective cost accounting system. In still another company handling over six million dollars of business in a very complex and diversified line, one cost accountant and one clerk are responsible for the operation of the cost accounting system, including the development of data for the preparation of operating statements by product classification and for very refined variance analyses. In addition, they are called upon to furnish cost estimates for a large volume of special quotations. It is no exaggeration to say that in any of these particular cases, a system of cost accounting based upon the accumulation of actual costs would entail two to four times the clerical expense with substantially reduced benefits accruing therefrom.

Initial Objectives

In closing, two policies are urged upon the accountant in designing a standard cost accounting system for the small manufacturer. First, keep the initial system as simple as possible. Be satisfied with the major advantages of cost accounting at the outset, postponing refinements until the basic system is operating fully and efficiently. Do not hazard the success of the entire system by elaborate detail. Do not expect to answer all possible questions from routinely developed data—depend heavily upon special analyses in this regard.

Second, get the system into operation as rapidly as possible and start to show results. If you are faced with an unusually extensive program of developing standards, consider only partial coverage at the outset—perhaps coverage of only one type of product, or one element of cost, or one manufacturing department. Systems can be installed piecemeal with sufficient thought and careful planning.

The problems in designing a cost accounting system for the small manufacturer are numerous, but the results of a well-planned and properly installed system are most rewarding.

AN ADIRONDACK VIEW

How big is small? No, not CPA firms, business organizations.

Some years ago a big business was usually defined as one with over a million dollars in assets. But that idea got no farther up the street than the bank—a bank can be very small and have much over a million in assets.

Then someone added to the definition the employment of over 500 people. But a necktie manufacturer with 400 employees and $100,000 in assets thereby remained small by definition, but big in fact and in the necktie business. It would also turn out a big mess of neckties—including some decorated with numbers, some with ducks, and probably some with hellgrammites.

But now the child has been born, the sun has risen, the definition has arrived, thanks to Washington (D.C., not George). SPDA did it—the Washington bureau which has no top—the Small Defense Plants Administration. Assets are omitted. You are small if you have less than a certain number of employees per a table of industries. If you make venetian-blinds, 50 employees makes you big. If you make locomotives, it takes 2,500 employees to make you big.

And so we learn that simple answers are for simple things; that complex things need complex answers; and simple answers for complex things are usually a snare for the unwary.

Leonard Houghton, CPA
Of the Adirondack "Chapter."

Accounting Problems of Advertising Agencies and Related Auditing Procedures

By Melvin N. Gelber, C.P.A., *and* Joseph M. Geller, C.P.A.

After describing the principal activities of an advertising agency, the authors discuss the more important accounting problems arising out of its sales of space and services of production. Audit procedures unique to this type of enterprise are also presented.

Principal Agency Activities and Related Accounting Objectives

"99-44/100% Pure! It Floats!", "The Pause That Refreshes!"

Did you think of the products which these slogans represent? If you did, the efficacy of modern-day advertising is amply demonstrated. The great importance of advertising in the competitive atmosphere of business has created the need for specialists in this field. The result of this need is the modern advertising agency which is uniquely equipped to render a variety of services.

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From an operational standpoint, the principal activities of an advertising agency consists of space- and time-buying and production. Space- and time-buying involve such media as newspapers, magazines, radio, television and billboards—avenues through which the seller's product is brought before the public. Production, on the other hand, involves the creative, "behind the scenes" work of the advertising agency which is necessary to produce the printed advertisement or the commercial script of radio and television. Some of the materials utilized in production which are considered a part of production are art work, photography, mats, and engravings. Besides the printed ad and commercial script, such material as brochures, pamphlets, catalogues, and direct mail are created by advertising agencies and are generally classified by them as production.

The agency often engages in activities other than those just described, such as planning advertising campaigns, publicity and research. These, however, do not involve the specialized accounting treatment utilized in handling space- and time-buying and production activities and will, therefore, not be considered. Similarly, agency problems such as those relating to credit relations, account executive commissions, budgeting, rebates and refunds

will be by-passed in order to highlight the accounting treatment relative to the principal functional activities of the agency.

While the term "agency" is used, it is, in a sense, a misnomer since, legally, the agency acts independently of its client, the advertiser, on the one hand, and the various media and vendors of production material on the other. However, the essential nature of an agency remains in that liabilities for space, time, and production costs are incurred by the agency for the benefit of the client and must be accurately stated by the agency and reimbursed by the client.

With this in mind, it can be seen that an efficient accounting system for an advertising agency should provide for the accurate and expeditious billing to the agency client of space, time and production costs incurred for the client and, simultaneously, for setting up the proper agency liability for the aforementioned costs.

Accounting Problems in Relation to Space

While the problem of accounting for media placement is not as complex as that of production, the comparatively larger amount of funds involved spotlights this problem.

Agencies are required to pay media generally within ten or fifteen days subsequent to the month in which the advertisement is placed. Therefore, it is imperative that agency billings to clients should be made far enough in advance to insure prompt payment. Failure to bill early enough would place a tremendous financial burden upon the average agency which might possibly impair its working capital. Prompt billing can be greatly facilitated by billing the client on an estimated basis before actual space or time can be checked. Adjustments for differences such as shrinkages, overages, errors, short rates, and rate reductions may be made by the agency at a later date.

The billings are recorded in a journal which differs from a commercial sales journal in that liabilities to media for cost of sales are recorded simultaneously with the sales. In reality, this journal becomes a Sales-Cost Journal and should generally be referred to as such. The basic transactions recorded therein can be best illustrated by the following entries:

Accounts Receivable	$1,000.00	
Sales—Media		$1,000.00
Cost of Sales—Media	850.00	
Accounts Payable—Media		850.00

It is obvious that the foregoing entries serve the dual purpose of setting up the proper asset and reflecting the corresponding liability. Agency liabilities to media, therefore, are always on the books at the close of the accounting period even though invoices may not have been received from the media.

Agency commissions are generally 15%. Media invoices to agencies for space or time purchased are at fixed rates less 15%. Corresponding agency sales invoices to clients are at the fixed rates, thus resulting in a profit of 15% to the agency. The accuracy of the entries in the Sales-Cost Journal can be checked by ascertaining whether the total Cost of Sales-Media at the end of the month is equal to 85% of the Sales-Media. This is usually referred to as the 15% Test.

The Sales-Cost Journal should also be columnized to provide important statistical analyses of billings by various classifications of media (newspapers, magazines, television, etc.) and other information, such as distribution of billings by account executive to facilitate commission computations if so desired by management.

Adjustments for shrinkages, overages, short rates, and rate reductions are also made in the Sales-Cost Journal by appropriate charges or credits, bear-

ing in mind that all changes in sales billings should have corresponding changes in the cost of sales.

Accounting Problems in Relation to Production

The salient feature in accounting for production is the setting up of inventory control for all production purchased. Expenditures incurred on behalf of clients such as photography, art work, paper and mats should be corralled into inventory in order that the agency may keep an accurate record of these costs and eventually recover them.

Mechanically, this is accomplished by charging these costs to specific production jobs, the sum of which comprises the inventory control. When invoices are received, the following entry is made:

Work-in-Process Inventory (Job #123)	$1,700.00	
Accounts Payable—Production		$1,700.00

When the job is completed, the following entries are made in the Sales-Cost Journal:

Accounts Receivable—Production	$2,000.00	
Sales—Production		$2,000.00
Cost of Sales—Production	$1,700.00	
Work-in-Process Inventory (Job #123)		$1,700.00

In order to apply the 15% Test, it should be noted that the cost of production must be increased by 17.65% in order to get 15% of sales. This, however, is a matter of agency policy which varies with different agencies. When 15% is added to the cost of sales, the resulting commission is only 13% of sales. The following illustration graphically depicts the comparative results of agency billing production expenditures at 17.65% and 15% of cost of sales:

	I	II
Cost of Sales	$ 850.00	$850.00
Commission:		
I		
17.647% of $850.00 / 15% of $1,000.00	150.00	
II		
15% of $850.00 / 13.043% of $977.50		127.50
Sales	$1,000.00	$977.50

Thus far, only production costs incurred with outside vendors have been considered. It is not uncommon for the average advertising agency to maintain its own production departments such as art, photography, and copy. These departments may range from a single person to a staff of many, and may utilize art, photographic and other equipment involving a comparatively large investment. Costs incurred in operating these departments are charged to the particular production department expense accounts. It is important that time records be kept in the production department and a department overhead rate be established so that the cost of this internal work may be properly charged to the various jobs in progress. This charge is reflected in the following typical entry:

Work-in-Process Inventory (Job #123)	$400.00	
Production Department Expense		$400.00

The remaining costs in the particular production department expense account will then represent unbillable costs, such as idle time or promotional work performed by the department to obtain new accounts or to increase the programs of current accounts.

A convenient method of keeping a record of all job costs utilizes job envelopes numbered in accordance with the jobs in progress. Copies of all invoices are kept inside the envelope. Costs are listed and accumulated on the face of the envelope. The accumulated costs should at all times equal the amount charged to the Work-in-Process control account. The costs on the face of the envelope are summarized when a job is completed and used as the basis for the billing to the client and for the resulting sales and cost of sales entries. The use of job envelopes facilitates the furnishing of an accurate description of production costs to the agency client on billing.

Auditing Procedures

Audit procedures with respect to the assets and liabilities of an advertising agency generally do not differ in principle from those followed in the audit of the average business. The examination of the books and records of the agency is influenced by the nature of the business and by the extent of the internal accounting controls utilized by the agency.

Only audit procedures of those assets and liabilities and related income and expense items unique to the advertising business and discussed in connection with the basic accounting problems of the advertising agency are considered here.

Accounts Receivable

If the agency maintains separate general ledger controls for amounts due from customers for media space or time rentals and for production work, these controls should be reconciled with the detailed listings of accounts receivable. Independent written confirmation of outstanding amounts due as at the balance sheet date should be obtained. An ageing of the accounts receivable should be made and past due accounts discussed with management. An adequate reserve for doubtful accounts should be set up.

Media sales invoices entered in the Sales-Cost Journal in the month subsequent to the balance sheet date should be examined to determine whether any apply to the year under audit. Pertinent work-in-process job envelopes should also be examined and the closing date of the job stamped on the face of the envelope verified to determine the accuracy of the sales invoice billing date. Any adjustment required by such examination would also necessitate an adjustment of the corresponding liability to media and the media cost of sales.

Accounts Payable

If separate controls are maintained for amounts owed to media, for liabilities to vendors for outside production purchased, and for liabilities for all other items, these controls should be checked with the detailed schedules of accounts payable. Confirmations should be obtained from all vendors and differences, if any, reconciled with book balances.

Differences in accounts payable to media may be disclosed if the agency bills its clients and records corresponding cost of sales on an estimated basis prior to receiving invoices from media. Any adjustment of Accounts Payable-Media required will produce a similar change in Cost of Sales-Media and will require an adjusting entry dealing with the related Accounts Receivable-Media and Sales-Media accounts.

Vouching of invoices received from media and recorded in the Sales-Cost Journal in the month following the balance sheet date should be performed in order to disclose any increase or decrease in liabilities to media pertinent to the period under examination. Any media accounts payable adjustment required as a result of the vouching will

naturally encompass the related asset and sale.

The vouching of invoices representing purchases of outside production from vendors is discussed in connection with the work-in-process audit procedures. Appropriate vouching tests should be made of all invoices other than those representing liabilities to media and vendors of outside production.

Work-in-Process Inventory

The inventory of work-in-process should consist of production costs resulting from incomplete jobs unbilled to agency clients as of the balance sheet date. All work-in-process job envelopes should, therefore, be examined to make certain that no job costs remain in inventory subsequent to publication or release date. The closing date of the job should be stamped on the face of the envelope together with the billing date to the client and the sales invoice number. The billing should then be checked to the Sales-Cost Journal. If the closing date is prior to the balance sheet date, and billing to the client is not indicated by the appearance of the billing date and sales invoice number on the envelope, adjustment for the billing and corresponding cost of sales should be made.

All production costs which are determined to be unbillable should be removed from the work-in-process inventory and charged to an appropriate account such as "Unbillable Production Costs."

A vouching test of invoices from vendors of outside production and other items entered in the voucher register should be made in order to check their distribution and determine that all amounts belonging in the work-in-process inventory have been properly charged. Job numbers on completed work-in-process envelopes should be accounted for by appropriate tests. Supporting invoices in the envelopes tested should be checked against the listings on the envelopes, the voucher register entries and related sales invoices.

Miscellaneous

Examination of current media placement orders unfilled by the media as of the balance sheet date, but past cancellation date, should be made in order to calculate the contingent liability of the agency to media and the contingent asset from clients. An appropriate comment may be made concerning these contingencies in the report accompanying the financial statements.

Financial Statements

The balance sheet of the advertising agency contains the customary arrangement of assets, liabilities and capital. The work-in-process inventory is listed on the balance sheet under a more descriptive title such as "Unbilled Production Costs." The operating statement is prepared to conform to the nature of the business showing sources of income and the direct costs applicable to each source. The 15% Test should be used as an over-all check by the auditor in the preparation of the profit and loss statement. If the commissions earned from the various types of media and production sales are less than 15% on the statement, the reasons for the variation should be determined by analysis and commented upon.

Highlights of an Audit of an Insurance Company

By Paul W. Pinkerton, C.P.A.

The highlights of the audit of fire and casualty companies are pointed up in this article. The differences in audit procedure occasioned by the peculiar nature of this regulated form of enterprise are indicated, as are the variations between generally accepted commercial accounting principles and insurance accounting practices.

The operations of an insurance company involve two major activities: first, underwriting, including the obtaining of business and the settlement of claims resulting from losses; and second, investing. Briefly, the insurance company receives a premium for assuming a specified risk, generally for a definite period of time. It might be considered that this premium is held in trust for the policyholder, to the extent that it is not earned, for the payment of losses or for return in event of cancellation of the policy. Assets representing these unearned premiums and the capital and surplus of the company must be invested in order to yield a return rather than remain idle.

This discussion will be limited to fire and casualty insurance companies, and will not touch on companies writing life insurance.

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This paper was presented at a technical meeting of the Society, held on May 3, 1951, in New York, under the auspices of the Committee on Insurance Companies and Agencies Accounting.

The System of Internal Control

The auditor's first consideration is the system of internal control in effect during the period to be covered by the examination. The extent of tests of premiums, commissions, losses, and other transactions can be determined only after careful analysis of this system. This analysis will, of course, be continued during the progress of the audit, as the effectiveness of the system is tested. The average fire insurance policy involves a very small premium, perhaps \$25 to \$50. A premium volume of \$10,000,000 a year would thus indicate perhaps 300,000 policies or endorsements. Casualty policies, other than such classes as workmen's compensation and surety, are also small. The average loss payment is larger, of course, but again there is a large volume of small items.

Interim Audit Work

The auditor should read the various policy contracts and forms used by the company to acquaint himself with the types of business written. He should also determine the types of reinsurance coverage purchased by the company, particularly as to any blanket contracts, or treaties.

The auditor will want to accomplish a major portion of the audit before the end of the year. Indeed, he has little choice in the matter, for two reasons. First, there is very little time after the close of the year to complete the examination. All insurance companies report on a calendar year basis, and in New

York the reports must be filed by March 1. Secondly, much of the basic information is contained in punched cards, which are used for several purposes and may shortly after the year-end be filed in a different order. The most practical time to audit certain records is at the time they are prepared, any listings required by the auditor being made at that time. One factor to be considered is that the time limitations result in a reluctance by the companies to be overly concerned with accounting niceties at the year-end.

Premium Income

The audit of premiums written by an insurance company is similar to the audit of sales of a commercial enterprise. One very important difference is that with respect to premiums there is not the control afforded by inventories and expected gross profit. In my opinion, the planning of an examination of premiums will tax the ingenuity of the best of auditors. Incidentally, this is one phase of the audit that can be substantially completed before the year-end.

One of the interesting things about the examination of premiums, commissions, reinsurance, and losses is the interrelationship of these items, which should be considered in planning the work. For example, in testing charges for facultative reinsurance ceded to other companies, the auditor would also examine the copy of the policy reinsured to see that proper notation was made of the reinsurance. In his tests of payments of losses and of return premiums, the auditor must rely on this notation to determine that proper recoveries are received from the reinsurer. Details of premiums and commissions, reinsurance premiums and reinsurance commissions, and corresponding returns, are examined together, there being only few instances where there are premiums without commissions or vice versa. In testing the recording of premiums, etc., the auditor should also observe that the terms and expiration dates are recorded properly, as the calculation of the unearned premium reserve is based on this information. In examining loss payments, the auditor should observe that a loss which has been paid is not also included in the list of unpaid losses.

Expenses

There is generally a close relationship between commissions and premiums. The audit should include a careful study of average rates, by periods, by classes, by territories, and so on, in the search for possible irregularities or errors.

The expense accounts, as well as many other accounts, of an insurance company are kept on a cash basis, so that a major part of the examination is essentially a cash audit. The examination of salaries and other operating expenses would be undertaken during the preliminary work, as would a portion of the audit of investment income and transactions. A uniform classification of accounts was adopted by insurance companies recently.

Receivables

Confirmations of receivables, on a test basis, could well be requested as of the end of some month prior to the end of the year, September or October, for example. One of the major problems in the examination of receivables is the obtaining of satisfactory confirmations from policy-writing agents. Because of the time lag in recording these policies on the company's books, there will be as many differences as in a like number of bank reconcilements. If the agent renders monthly accounts of premiums written, the agent should be requested to confirm the balance indicated by his accounts, which would then be reconciled with the company's book balance. If an agent were to be asked to confirm the balance shown by the company's books, it would be necessary to send an itemized statement to be checked by the agent. Since he has already

reported the premiums entered on his books, however, the burden of reconciling should not be placed on him.

Liabilities to reinsurers, which are deducted from receivables in the statements, should be verified by obtaining confirmations on a test basis. This is also true of receivables from other insurance companies for reinsurance recoverable on paid and unpaid losses.

The question of evaluating the receivables, in order to establish an allowance for uncollectible accounts, does not arise in the audit of an insurance company. The reason for this is mentioned below.

Investments and Investment Income

The investment activities of an insurance company are similar to those of an investment trust, and the procedure for auditing the investments and investment income are the same as would be used for an investment trust, or for the investments of any company. If the securities are held by a bank or trust company in a custody account, it would appear unnecessary for the auditor to inspect them, but he will, of course, obtain a certification and reconcile the securities shown with those shown by the books.

Detailed audit programs for investments are presented in the American Institute of Accountants' Case Study in Auditing Procedures, No. 6, entitled "A Management Investment Company of the Open-end Type," and in Mr. Francis G. Connelly's article in the April, 1950, *New York Certified Public Accountant,* "Auditing Procedures Relative to Marketable Securities."

Investments are carried in the accounts at cost, with a few exceptions. Bonds with ratings below those required by the National Association of Insurance Commissioners and all stocks are reported in statements at market values promulgated by the Association. Other bonds are reported at cost adjusted for amortization of premiums and accumulation of discounts. The difference between book values and values used in the Annual Statement is treated as a non-ledger asset (if market value is greater) or as a non-admitted asset (if the reverse). In actual practice, many companies do reflect the changes in their general books, but in a separate account. Other companies follow the traditional practice of not entering year-end adjustments, accruals, etc., in the books. The amounts traditionally carried in the ledger are referred to as ledger assets; adjustments are non-ledger assets or non-admitted assets, depending on their direction.

One variation from commercial accounting practice with respect to investments is the treatment of accrued interest as a non-ledger asset. As in the case of other non-ledger assets, accrued interest is often recorded on the ledger, but in a separate account, the income accounts being kept on a cash basis. The entry of the accrual is reversed in the succeeding year.

Real estate and mortgage loans are other investments of insurance companies. These are examined according to customary procedures.

The brevity of this discussion of investments and investment income should not be construed as a measure of the importance of this phase of the audit, but rather as a recognition of the excellent material available, such as the articles just mentioned.

Liabilities

The two major liabilities of an insurance company are not encountered in the audit of any other type of company. These are the liability for losses and the liability for unearned premiums, which are peculiar to insurance companies.

The Loss Reserve

The computation of the liability for losses, generally called the loss reserve, is essentially arithmetical, rather than actuarial. The balance of the reserve represents the sum of (1) the estimated

cost to settle known claims, (2) the estimated cost to settle claims which have not yet come to the company's attention, and (3) the estimated expense of adjusting the claims. The first is simply the aggregate of the estimated amounts to be paid on losses reported to the company before the year-end.* The second, the reserve for unreported losses, is the management's estimate, based on past experience as to the delay in reporting losses, modified by any factors which might alter this experience. For example, a catastrophe occurring near the year-end, such as last year's windstorm, would require an increase in the reserve for unreported losses over that indicated by experience. The management's estimate of the cost of adjusting outstanding claims, including those not reported, is also based on experience, primarily as to the average ratio of loss expenses paid to losses paid. In computing all three portions of the reserve, reduction is made for recoveries to which the company is entitled from reinsurers — those who have agreed to assume a portion of the company's losses on specified policies or lines of insurance.

The audit of unpaid reported losses is based on an analysis of the company's procedures for estimating and recording losses as reported, and the internal control over these procedures. This analysis is supplemented by tests of the detail records, both as to the proper inclusion of reported claims and as to the exclusion from the reserve of claims which have been settled. The management's estimates of incurred but unreported losses and of loss expenses should be reviewed for reasonableness and the calculations should be examined.

Unearned Premium Reserve

The reserve for unearned premiums is also an arithmetic computation. It is computed solely on the basis of prorating the premium over the term of the policy. This method is common to other industries providing services paid for in advance, such as magazine and newspaper publishers.

For an insurance company with an annual premium volume of $25,000,000, there would be perhaps 500,000 premium entries per year. If the average policy is written for a term of three years, there might be 1,500,000 policies or endorsements (comprising the current year and the two preceding years) in effect or in force at the year-end, on which the unearned premium would be computed. Obviously, the computation would not be made by computing the unearned portion of each premium. Instead, the method used is to determine premiums in force by what might be called a perpetual inventory method. As premium entries are made they are classified by term (number of years) and year (or month) of expiration, and the total of all premiums with the same term and expiration is determined on a continuous basis. At statement dates, the unearned premium is computed on the totals. Where only the year of expiration is used, it is apparent that the calculation is based on the assumption that the average policy expires on June 30. The annual pro-rata basis is generally used by fire companies; the monthly pro-rata basis is used by casualty companies.

Since it is not feasible for the auditor to verify the premiums in force at the audit date by means of a "physical inventory," an alternative method must be used. Because of the large number of relatively small premiums, the principal step in the audit is the analysis of procedures and internal control. This analysis is supplemented by tests of the accuracy of the recording of basic data in the premium and reinsurance registers. These tests are made at the same time as the examination of premiums written. The summarizing of these data to arrive at premiums in force is also tested. The arithmetic computa-

* A technical exception to this statement exists with respect to certain casualty lines, where certain minimum reserves, based on premiums written, are required.

tion of the unearned portion of premiums in force at the audit date should be verified, and the totals by classes of insurance reviewed for reasonableness.

The Auditor's Report

One problem confronting the auditor is that of the best manner of presenting his opinion on the financial statements. Mr. Stanley E. Shirk's excellent article in the September, 1950, Journal of Accountancy, entitled "Is There More Than One Set of Generally Accepted Accounting Principles?" contains some thought-provoking comments on certificates relating to the financial statements of insurance companies, as well as of companies in other regulated industries.

Variations Between Generally Accepted Commercial Accounting Principles and Insurance Accounting Practices

This is not the place for a complete discussion of the variations between generally accepted commercial accounting principles and insurance accounting practices. The basic reason for the differences is that the insurance laws were designed for the protection of policy-holders, so that the required statements are directed toward policyholders and prospective policyholders rather than toward investors. The insurance laws of the various states prescribe what assets may be admitted and what liabilities are required. These laws also require that any published statements show the surplus determined in accordance with the law, so that these statements are usually condensed from the convention statement filed with the insurance departments of the respective states in which business is underwritten.

Failure to Match Premium Income With Acquisition Expense

Perhaps the most important variation results from the failure to match premium income with acquisition expense. As we have already discussed, premiums are taken into income over the life of the policy on a pro-rata basis. On the other hand, no part of the agent's commission or other costs of obtaining the premium is deferred, even though these costs are in part applicable to future income, are generally definitely ascertainable, and are recoverable pro-rata almost without exception in the event of cancellation or reduction of the policy. These costs are generally considered to aggregate between 35% and 40% of the premiums, so that some financial analysts add 40% of the unearned premium to surplus as a basic adjustment. This amount is referred to as the company's equity in the unearned premium reserve. In many cases this adjustment alone would more than double the value per share of stock outstanding.

Non-Admitted Assets

Of less importance, but often aggregating material amounts, are the non-admitted assets. The exclusion of assets from the balance sheet is made according to fixed rules, which leave no room for consideration of the value of the assets. Some of the assets which may not be considered in computing surplus are:

1. All fixed assets, other than land and buildings.
2. All balances over 90 days old due from agents or brokers, and uncollected premiums over 90 days old.
3. All bills receivable not taken for premiums.
4. All loans on personal security.
5. Unearned premiums paid to, and reinsurance recoverable from, companies not authorized to do business in the particular state (unless secured by cash deposits).
6. Company's stock owned or loans secured by the company's stock, and
7. Supplies and prepayments of all kinds, except prepaid real estate taxes.

Non-Segregation of Surplus Components

The Annual Statement of an insurance company does not require any showing of the composition of the surplus balance, that is, a segregation between capital surplus and earned surplus. This, of course, is a departure from generally accepted practice of commercial corporations.

Reporting Practices

Some stockholders are not familiar with the variations between generally accepted principles of commercial accounting and the practices required by insurance laws. Since it is not within the scope of the auditor's report to explain these differences and their effects, this gap must be filled by financial analysts, for the present. The method of reporting used by certified public accountants generally is the most satisfactory, I believe. Details of non-admitted assets are presented in footnotes, together with certain other material information. Some certified public accountants go further and explain briefly the company's equity in the unearned premium reserve. This appears to be gratuitous, in view of the opinion, which states merely that the statements conform to regulations of the state insurance department.

Others, however, follow practices which I believe are not acceptable. One auditing company, for example, in reporting on an insurance company, gives a schedule of non-admitted assets, but does not mention the failure to match income and expense. The opinion paragraph then states that the statements, in their opinion, present the position and results of operations of the company "in accordance with generally accepted principles of both insurance and general accounting practices." You can judge for yourselves whether that is possible.

Summary

For those who might be called on to audit an insurance company for the first time, I would like to review, in a few words, the approach to the audit. Any general audit requires an examination of assets and liabilities, and income and expenses. The differences between the accounts of an insurance company and those of a commercial organization are not so great as might be expected. Therefore, as in the audit of any company whose operations are unfamiliar, the approach is to determine what the differences are as the audit proceeds, and mould customary procedures around these variations. The primary accounts which are peculiar to insurance are the loss reserves and the unearned premium reserves. In addition, regulations require fundamental differences in accounting treatment, but these do not, for the most part, involve any difference in the audit approach. For example, past-due accounts should be examined, even though they may not be included as assets in the Annual Statement. As in any audit, the charter, by-laws, and minutes should be read.

I have not attempted to discuss all phases of an insurance company audit. Many important features have not even been mentioned. I have limited myself to what I consider to be the highlights of such an audit.

Some Notes on Insurance

Including An Annotated List of Suggested Readings

By LEO ROSENBLUM, C.P.A.

In this article the auditor's role in reviewing the client's insurance coverage is discussed. The range of pertinent information required in this connection and, if needed, the sources of informed insurance information and opinion are both considered. Appended is a selected bibliography of useful published materials, which should contribute to a more effective analysis of underwriting requirements and loss claim problems.

REVIEWING the client's insurance coverage is an important phase of the independent auditor's work in the examination of financial statements. The auditor seeks to ascertain whether there is insurance, in sufficient amounts, against the various classes of hazards.[1] The amount of coverage is important; too little insurance—or the wrong kind—may place an important asset in jeopardy.[2] Accordingly, the preparation of a detailed schedule of insurance and an audit of the policies is recommended.

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Although the "auditor is not an expert in determining insurable values," observes Montgomery, "he may sometimes render helpful service to his client by comparing the amount of coverage with the insurable value (if available) and book value of the property insured." [3]

Credit grantors frequently request borrowers to fill in financial statement forms, and to respond to many questions about the borrower's business affairs. Frequently an insurance schedule is called for. And quite often the client asks the public accountant to complete the forms and prepare the responses to the questions.

In a subtitle to his paper on "Accountants and Insurance" in *Credit and Financial Management*[4], Joseph Getz, C.P.A., asks "Should They Be Held Responsible for Opinions on Coverage?" His answer is: "The accountant is not an expert on insurance matters, and should not profess to be one and, therefore, should take no responsibility for the adequacy of insurance coverage. What he may do along

[1] *See* Byrnes, Thomas W., Baker, K. Lanneau, and Smith, C. Aubrey, *Auditing,* N. Y., Ronald, 1948, p. 335.

[2] *See* Goodman, Max, "Insurance Problems in Real Estate Audits," in *New York Certified Public Accountant,* Vol. XIX, No. 7, July 1949, p. 432.

[3] Montgomery, Robert H., Lenhart, Norman J., and Jennings, Alvin R., *Montgomery's Auditing,* 7th Ed., N.Y., Ronald, 1949, p. 315.

[4] Getz, Joseph, "Accountants and Insurance," in *Credit and Financial Management,* Vol. 49, No. 2, February 1947, pp. 8, 20.

these lines is purely gratuitous, and should not be construed as a competent opinion on the subject. It is for others, whose business is to evaluate risks, to evaluate this one." [5]

It appears to be the consensus that practicing accountants should inspect the client's insurance policies, noting the coverage—subject matter, locations, amounts, exclusions, and other important matter. Then, wherever possible, they should ascertain, with the assistance of the client or his representatives (managers, insurance brokers, company representatives, or other insurance counselors) whether the coverage is adequate, *i.e.*, whether all the hazards or exposures known about, or likely to occur, are covered.[6]

This poses several questions for the public accountant:

1) What types of coverage should a client carry? Clearly, the answer will not be the same for each client.
2) What are the essential characteristics of each type of insurance available?
3) What new coverages, or policies, are available?[7]
4) How can the accountant round out his information on these points most efficiently?

The wide range of insurance information needed by the public accountant is illustrated by these quotations from an editorial on "Audits and Fidelity Bonds" in the *Journal of Accountancy*[8]: "A committee of the American Institute of Accountants which has been studying the subject believes that members of the Institute should intensify their efforts to persuade clients to carry a sufficient amount of this type of coverage." Of course, "Questions as to the type of fidelity bond best suited for a particular client, will presumably be referred to the client's insurance brokers, since they are generally best informed on the subject."

The auditor should know what types of fidelity bonds are available, so that he may be "in a better position to appraise the adequacy of this protection as a factor in the system of internal control," Brink points out.[9] Nevertheless, Brink notes further, the bond must be read carefully, particularly in the event of a loss, since the nature, amount, and limits of coverage vary among different bonds.

It cannot be overstressed that in reviewing the types and amounts of insurance carried by his client the accountant does not take over the role of the insurance broker, agent, or consultant. Rather, it is expected that his knowledge of the business under review may "prevent . . . errors in insurance arrangements . . . [and] may bring forth hitherto undisclosed facts important to the audit. For instance, a fire-insurance contract may indicate that the loss is payable to other than the owner-insured, thus reflecting an otherwise undisclosed lien on merchandise or inventory."[10]

One practitioner suggests that, concerning owners of small businesses, the accountant go a step beyond the insur-

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[5] *Ibid.*, p. 8.

[6] And *see* Brink, Victor Z., editor, Auditing Practice Forum, "Insurance Coverage of Fixed Assets," in *Journal of Accountancy*, Vol. 83, No. 4, April 1947, p. 325.

[7] For example, consider "Depreciation," "Replacement Cost," or "Repair or Replace" insurance, which, though in existence for many years, was encountered infrequently until comparatively recently. Under this form, fire policies may be supplemented to provide coverage, at additional cost, of replacement cost, that is, cost before considering depreciation, on buildings and building service equipment.

[8] "Audits and Fidelity Bonds" (Editorial), in *Journal of Accountancy*, Vol. 81, No. 2, February 1946, p. 92.

[9] Brink, Victor Z., editor, Auditing Practice Forum, "Examination and Reading of Surety Bonds," in *Journal of Accountancy*, Vol. 82, No. 3, September 1946, p. 250.

[10] Chan, Stephen and Miller, Jerome S., "The Audit of Insurance," in *Journal of Accountancy*, Vol. 80, No. 6, December 1945, p. 444.

ance covering the business itself.[11] He recommends review of the personal insurance coverage of the owners of the business. A sizeable claim for personal injury may force the withdrawal of funds from the business to defend or settle the claim.

The adjustment of insurance losses will concern public accountants from time to time. How can an accountant assist his client—if requested to do so—when an insured loss occurs? What steps must the accountant take? In what order? What records must be supplied to the insurance companies? What reports? To what extent are book values employed as bases for claims?

To assist the accounting practitioner, the writer has prepared the following list of readings on insurance. The list consists of: (1) a section containing texts on insurance, classified by subject matter; (2) an annotated list of articles in periodicals and pamphlets.

This selective bibliography should simplify the busy accountant's search for published materials useful in connection with the audit of insurance coverage. Use of the list as needed will contribute to a more effective analysis of underwriting requirements and loss claim problems. Of course, the suggested readings do not exhaust the subject; there are — particularly among the texts on insurance — a number of other works in wide use.

[11] Heinsimer, Robert, "Suggestions for Public Accountant's Analysis of Client's Personal Insurance," in *Journal of Accountancy*, Vol. 87, No. 6, June 1949, pp. 489-490.

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Public Accountants Need to Gird Themselves Psychologically as well as Technically for Expanded Usefulness

By William L. Campfield, C.P.A.

Americans are today looking to their professinal men for guidance and counsel on many problems which typically have not been viewed as falling within the sphere of a given professional pursuit. This trend suggests to public accountants that they, too, are likely to be sought out more and more for the rendition of widely expanding services.

The increasing importance of the public accountant's role in modern society may be highlighted by the reflection that for any given financial situation the exercise of his judgment may vitally affect the interests of competing equity holders; may establish the basis of action by various federal and local regulatory agencies; and may serve as the focal point for the formulation of key decisions by managements, labor groups, potential investors, consumers, and a public at large.

It is fairly agreed in all circles that accounting determinations are the basis underlying the assessment and collection of most of the revenue of federal and local governmental agencies. It is also conceded that accounting determinations are highly important factors in the production and distribution of economic wealth. It would follow that since accounting affects so many aspects of modern industrial and commercial life, accounting judgments governing the ascertainment of costs and the determination of net income for individual business enterprises must be of immense social import.

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Yet in these circumstances the public accountant is no mere reporter of recorded business transactions. With the exception of the most simple type of enterprise his task is one of interpretation as well as verification of recordings; judgment as well as mere inspection of computations; artistry as well as that of scientific investigation. Truly, as James J. Caffrey, ex-chairman of the Securities and Exchange Commission, once remarked:

> "History has . . . thrust the accountant into a crucial role . . . the accountant's position has become a position of power. In this regard history has an even hand: With power she doles out responsibility."[1]

In no period of history have the public accountant and others been faced with such a multitude and complexity of problems calling for dispassionate and independent solution predicated upon a careful consideration of all the

[1] Paul Grady, "The Increasing Emphasis on Accounting as a Social Force", *The Accounting Review*, July, 1948, p. 270.

pertinent facts and with the public welfare as a controlling goal.

The thought that accounting measurements touch so many facets of human effort suggests that consideration of the soundness and propriety of any accounting judgment is barren which fails to embrace the social implications thereof. And currently, the public accounting profession is being subjected to a minute scrutiny from both within and without the profession to ascertain whether it has in fact assumed its role of proper responsibility based upon reasoned opinions.

The opportunity for universal confidence in accounting methods and purpose can persist only if the bases of accounting judgments are themselves adequately established and widely disseminated. Accounting practitioners have taken it for granted that the practice of public accounting represents the constant application of judgment to an infinite variety of situations and the public accountant need only be given the occasion and the freedom to exercise it.

But the belief is held by many that professional judgment in any area of endeavor is partly intuitive. Hence, when the other bases on which judgment formation is founded are not reasonably clear, actions which in reality express objective consideration may be easily misinterpreted by the public as representing intuitive action alone or even abject compliance with someone's deliberate wishes.

All of the foregoing points to the fact that public accountants need to be in closer harmony than they are on the elements which lie at the root of their decisions and upon the processes by which they strive to reach sound judgments in their professional work. If the profession's judgmental behavior pattern is demonstrably sound, there need be little resistance to a rigorous self-examination and probing before continuing to assume that its professional conduct unequivocally warrants the approbation of the public.

The Impact of Uncertainty and the Resultant Confusion in Thinking

Most individuals do some type of reasoning from infancy. When they reason within the framework of things about which they are familiar there is a tendency for them generally to reason adequately. But when faced with things they do not understand too well, the tendency is for the majority of people to reason poorly.

In the complex and fragmented society of today many an individual finds himself faced with practical problems that require solution but is left in a quandry as to where to turn for principles and guides to solution. The necessity for solving problems is not new, but the latter day need for referring even simple problems to a consideration of deep-rooted social standards and elements of character which are in conflict is indeed disturbing to the individual's reasoning mechanism.

Educators point out that the common content of social experience shared in the self-contained communities of yesteryear has been reduced by the minute division of labor and social differentiation accompanying an industrial and population expansion as witnessed in the past half century.[2] In the face of this, communication between individuals in society proceeds under great difficulty. There is still a commonality of language, but only in the sense of linguistic structure and words. The shared experience which imputes meaning to words is lacking and people everywhere have grown extremely distrustful of mere words and the concealed meanings that may lurk behind the form.

With the breakdown of language as an effective means of communicating thoughts and ideas, a general sense of frustration has arisen in a large segment of the population. But the most

[2] Clifford Woody, Editor, *The Discipline of Practical Judgment in a Democratic Society*, University of Chicago Press, Chicago, 1943, p. 10.

troublesome problems are induced by conflicting social and economic interests, incompatible modes of thought, and opposing orientations.[3] These conflicts, it is to be noted, generally arise less from non-availability of accurate information than from differences in interpretations of the same data attributable to differences in value orientations.

In times of stress these conflicts of ideas and interests are likely to result in a rush toward the polar extremes, and absolutism and conformity then become the rule of the day. This chasm thus creates a dire need for the appearance of more individuals in society whose training and whose experiences have conditioned them for considering facts and thinking through all situations.

But the possibility is meager that any given individual or a small group of individuals can understand the whole of their social existence and interrelationship and thus be adequately equipped to render reasoned opinions at any time on any problem. Walter Lippman has echoed the belief of many that in actual affairs of life men must select isolated phenomena about which to think, since they have only limited energy and but a short period in the inexorable march of time in which to observe and understand.[4] Only about a partial segment of life can it be expected that individual men will be able to think effectively and thus make a contribution to alleviating social confusion. Public accountants, though conversant with many segments of life, have attempted intensified observation and understanding of only a limited part of a segment, the economic.

Economic Change and its Relation to Uncertainty

Conceptually, the economic system of a nation is but one segment of the entire social structure fitting into the latter as an integral piece of the whole. In this well-integrated concept, each economic problem would seem to flow over into and, in turn, arise out of other segments. While at periods in the history of mankind it would appear that the economic system was reasonably in accord with the rest of the parts of the whole of life, there have been times when great alterations have been occasioned in this system and these have wrought profound changes in the stability of other factors in the social structure.

During the relatively brief history of the economic system we know as capitalism, there have been several periods in which attempts at revolution have been made. In the Britain of a hundred years ago following depression and amidst outcries of alarm, Disraeli, Mill, and Carlyle gazed upon the then emerging industrialism and found it seriously wanting. The counterpart of this scene was repeated in the United States fifty years ago following another depression and an extraordinary increase in urban population with its attendant dislocations. The condition of America of that day alarmed Thorstein Veblen, Simon Patten, and a host of others who clamored for new moral values and the adoption of a public policy based on greater social responsibility.[5]

In both of the cited periods of history the values employed in advocating a change in the social structure were not economic but moral. Again today in the wake of a catastrophic depression and an equally devastating world war we are in the throes of a searching re-examination of the economic system under which our society is structured.

Although efforts are constantly made to cushion the impact of economic change, affected groups of Americans now, as in the past, have generally

[3] *Ibid*, p. 16.

[4] Walter Lippman, *The Good Society*, Little Brown and Company, New York, 1941, p. 31.

[5] Louis M. Hacker, "Capitalism and Economic Progress", *The American Economic Review*, May, 1950, p. 105.

fallen into two extremely vocal groups: those who explode in an emotional outburst at the change, and those who indulge in an inordinate and non-critical lauding of economic change without serious regard for the cost involved.

This is the environ in which the public accountant has his most immediate and intimate contact. It ill behooves him, if he is to be of maximum service to the public interest, to become camp follower either of the emotionally distraught or of the enchanted braggard.

In an earlier day and under a less complex industrial pattern, the assumptions of a classical doctrine of economic individualism and laissez-faire posited an efficacious system of production and consumption for society. Contained within this system was its own mechanism of demand-supply factors which would automatically adjust for dislocations and re-establish the equilibrium so essential to its functioning.

During the twentieth century, however, there have been so many modifications and exceptions to the classical assumptions as manifestly to mark a significant departure from the doctrine of economic individualism and laissez-faire. In its stead there has been a gradual but perceptible trend toward the substitution of group action in place of that of the individual.

During this new era, those groups which have mastered sufficient voice to influence political and economic thinking have been able to draw around them a blanket of protection against economic and physical uncertainties, whereas others who have neither the strength nor the willing ears of legislative groups find themselves unhedged against the vagaries of a real world.

Thus a critical scene confronts the man who would reason. A continued recession from economic individualism is implicit in the pattern of the prevailing contemporary political and economic thinking. But the public accountant's worth to an economic society such as ours is contingent in large measure on just the type of individualism which pioneered the enterprise structure we know.

The Challenge to Personal Responsibility

When faced with problems of uncertainty and crisis, many people will seek refuge by absorbing themselves in the mechanics of mere details. Intriguing as this may be, and oft times very necessary, it obscures the major problems of our contemporary civilization: that of resolving present economic and social conflicts and that of charting the course of civilization for the future.

Regardless of the manner by which labelled, the modern private enterprise system represents the economic embodiment of a philosophy which has as its roots an emphasis on responsibility of the individual rather than on groups. This system, whatever its merits or demerits, cannot exist if government or any other group agency rejects the basic concept of individual decision and conduct. For this would be tantamount to a rejection of the efficacy of a multitude of small adjustments to changing conditions (via actions of individuals and firms) in favor of a doctrine that there is a small stratum of persons, masters of good judgment, upon whom should rest the burden of adjusting their society to changing conditions.

Walter Hoving, the merchandiser, has observed that one of the most tragic consequences of current social confusion is an apparent loss of our deep-seated belief in freedom itself. He finds that the word is still used as frequently as ever but its connotation has changed. Instead there has been substituted for freedom a sort of parasitic security.[6]

Manifestly, many of the requests and demands currently made of the public accounting profession are typical of a default in the matter of personal responsibility. Countless users of financial statements for business enterprises desire to shift the responsibility for making decisions and using their own

[6] George E. Sokolsky, *Syndicated News Column,* August 19, 1950.

judgment based upon the most reliable factual data available. Instead they would seek a nostrum in predigested, standardized decisions served to them ready for actionable pursuit.

The Need for an Emergence of Measured and Considered Thinking

Modern living is accomplished in a society predicated largely on a division of labor and specialization. Each individual in society, whether a worker or entrepreneur, operates within a narrow sector. And this tends to increase the feeling of helplessness of each individual, for regardless of what he does he senses the coercive influence of larger forces not controllable within his own immediate area of individual concentration. Thus is posed a serious threat of futility that haunts the actions of individual citizens—a feeling that no matter how wide the knowledge of their field of specialization or how great their efforts, these are still insufficient for the solution of pervasive problems of the day.

Robert S. Lynd has vividly pointed up the sinister partial impotence into which modern progress has led us in revealing that, although in almost every phase of daily living there is increased demand for specialized knowledge, practically the entire burden of adaptation is left to the individual by the culture.[7] Now this would neither be harmful nor incompatible with a doctrine of individualism except for the fact that society erects rigid institutions without a recognition of concomitant responsibility to build new knowledge into the institutional forms that will encourage and facilitate the use in daily problem solving of the knowledge most people possess.

To the close student of cultural evolution such institutional rigidities are auspicious reasons for effecting cultural change, provided "the thinking has been done in advance and the desired course of action is carefully charted".[8] In absence of a reasoned approach, dilemmas will continue to be capped by nothing more effective than forensic exhortations or laments over the shortcomings of the institutional structures.

Hence, a turn to the professional man and society's challenge to him to assume what it deems his urgent and inescapable duty of broad social responsibility comes as no distinct surprise. Monsignor Fulton J. Sheen and Rabbi Joshua L. Leibman addressed themselves to this issue at the one-hundredth anniversary meeting of the American Medical Association. There they fervently implored the physicians to look about them, to use the same intellect, character, and integrity on behalf of the world's problems as they do in their professional consultation.[9]

This is but one of many indicia that numerous Americans are today looking to their professional men for guidance and counsel on many problems which typically have not been viewed as falling within the sphere of a given professional pursuit. This trend suggests to public accountants that they, as components of a profession the members of which reap a diversified experience with people and enterprises, are likely to be sought out more and more for rendition of widely expanding services. If this trend toward wider professional opportunities points to a long-term intensification of dependence on professional men then the public accounting profession, like all others, must gird itself for action—both technically and psychologically. Leaders in accounting thinking could well become the vanguard of economic statesmanship of the future.

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[7] Robert S. Lynd, *Knowledge for What?*, Princeton University Press, Princeton, N. J., 1948, p. 113.

[8] *Ibid*, p. 250.

[9] Editorial, "The Current State of the Professional Man", *The Journal of Accountancy*, July, 1947, p. 4.

New York State Tax Forum

Conducted by Benjamin Harrow, C.P.A.

New York Estate Tax—Exemptions

The estate tax is based upon the net estate which is the gross estate less the statutory deductions. The first $150,000 of the net estate is taxed at 1%, but there are certain exemptions which may be applied to reduce the $150,000. If a widow receives any property by bequest or devise there is an exemption up to $20,000. With respect to property willed to a brother or sister, there is an exemption of not exceeding $5,000 for each such person. It should be noted that under the New York law the exemptions reduce the tax in the lowest bracket.

Section 249q limits the exemption to transfers of property interests "indefeasibly vested." That has been the law since 1946. Prior to that date the exemption was allowed whether the estate transferred to the widow was present or future, vested or contingent, indefeasible or subject to defeasance. The only condition then obtaining was that the value of the estate the widow received could be determined with reasonable certainty.

This issue was before the Court of Appeals in a recent case.[1] A decedent had willed property valued at $11,619 outright to his widow. In addition, the widow was to receive one-half of the income from a trust as long as she remained unmarried. On the assumption that she would not remarry, the life estate was valued at $64,319.78. Under the present law, since the life estate depends upon a possible remarriage, the estate is a defeasible one and no exemption would be allowed with respect to it. Under the law in effect when this decedent died the issue was in doubt. The Surrogate's Court refused to allow any exemption for the life estate because the estate was defeasible and was impossible of computation by any formula recognized by law. In the Appellate Division the decision was affirmed with one dissent. The Court of Appeals reversed both lower Courts and allowed a full exemption of $20,000, instead of $11,619.

Ordinary life estates are valued on the basis of life expectancies and courts have long accepted valuations based upon mortality tables. Is it possible to value a life estate terminable by remarriage? The Court of Appeals argues that while this factor of uncertainty is added to the uncertainty of a life expectancy it nevertheless has been determined in remarriage tables that have had the approval of courts. The Court cites a federal estate tax case[2] upholding the use of an accredited remarriage table. It also points to the use of such tables in computing the value of commuted payments to widows under the Workmen's Compensation Law since

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[1] *Matter of Estate of John L. Keenan, dec'd.,* 302 N.Y. 417 (May 24, 1951).
[2] *Com'r.* v. *Maresi,* 156 F(2d) 929 (1946).

1917, and to Section 1334 of the Civil Practice Act authorizing the use of "The Casualty Actuarial Society's table on Remarriage or other tables accepted by actuarial practice" in determining the value of an interest in real property defeasible on remarriage.

In the *Maresi* case the Court said, "the one sure way to do injustice . . . is to allow nothing whatever upon the excuse that we cannot tell how much to allow." Since Section 249q did not in 1942 exclude from the exemption the transfer of defeasible interests, and since Section 249v does not prohibit the use of remarriage tables the Court permitted the use of such tables in valuing the life estate.

In the same case an exemption of $5,000 was claimed on account of a legacy to a brother who had predeceased the testator. That bequest went to the brother's children under the antilapse statute, Section 29 of the Decedent Estate Law. This statute, said the Court, did not vest the property in the estate of the deceased brother. Therefore, the children took the property from the testator and not through the estate of their father. Since the issue of a brother is not within the enumerated classes entitling the estate to an exemption, the $5,000 exemption was disallowed.

Losses on Mortgage Loans— Capital Loss or Ordinary Loss

Investments in loans secured by mortgages generally come within the definition of capital assets. A loss on such a loan would therefore be considered a capital loss with the usual limitations on the deduction. The Tax Court so held in a recent case.[3] If a taxpayer is in the business of lending money on mortgages, the loss would be an ordinary loss, fully deductible.

In commenting on this case in the August 1, 1951, issue of Business Reports on Taxes, J. K. Lasser suggests that a taxpayer establish a record of his business activities in the field of mortgage loans with lawyers, real estate men, and builders and also to designate this activity on the tax return. The State Tax Commission would not be so easily impressed with the mere say so of the taxpayer that he was in the mortgage loan business. The State looks upon such an activity as in the same category as activity in the purchase and sale of securities, particularly if the taxpayer is principally engaged in other business activities and the mortgage loan business represents merely the investment of surplus funds.

Real Estate Investments— Tax Aspects

Business Reports, Inc., has issued a memo on real estate investments under date of August 1, 1951, outlining twelve tax advantages of real estate investments as compared, for example, with security investments. Some of the advantages are of interest from the standpoint of the New York tax.

1. Capital gain aspects: Under the Internal Revenue Code a gain on the sale of real estate is taxable at lower capital gain rates, while losses under Section 117j are fully deductible. Under the state income tax law both gains and losses would be subject to capital gain treatment. If the property is used in a trade or business it is not a capital asset and both gains and losses would be fully taxable or fully deductible.

2. The writer notes that the full value of buildings may be charged off through the annual depreciation deductions even though the property is heavily mortgaged and the taxpayer's equity in the property is small. This advantage holds under the state income tax law.

3. Because of the depreciation allowance, part of the taxpayer's investment is returned to him without tax. The writer notes that the use of a declining balance method for determining depreciation will give the taxpayer a larger depreciation allowance in the earlier

[3] *Wainbright*, TC Memo, Dkt. No. 27461.

years. Under state law a taxpayer may also use the declining balance method. Article 175 of the Regulations permits a computation of depreciation in accordance with a recognized trade practice.

4. Interest and taxes: On unimproved property a taxpayer may under federal regulations take a deduction for interest on mortgages and real estate taxes or he may capitalize these payments. The capitalization of these expenditures gives the taxpayer a higher basis in the event of a subsequent sale. No similar provision is made under state regulations and such taxes should be deducted when paid or accrued.

5. Leasehold Improvements: No taxable income accrues to the owner of property by reason of improvements made to the property by a lessee even if the lessor repossesses the property. While the property may be worth more because of the improvements, no realization of income takes place until the property is sold. In the meantime the lessee may write off the cost of the improvements over the term of the lease.

6. The writer points out that if an owner leases his property he may still take the deduction for depreciation. That fact may determine the choice between selling property to a tenant and paying a capital gain tax or leasing the property to get the advantage of the depreciation deduction.

7. A sale of real estate may easily be effected as an installment sale, thus enabling a taxpayer to spread the realization of gain over a period of years. The writer notes that if the taxpayer requires cash he can borrow on the installment obligations.

Payments to a Widow

In a previous issue of the State Tax Forum[4] we commented on a ruling of the Commissioner of Internal Revenue making taxable the payments by an employer to a widow. Such payments had previously been treated as non-taxable gifts if made for a reasonable period after the death of an employee.

Presumably on the basis of the Commissioner's ruling the Tax Commission has revised Article 23 of the Regulations, which now provides[5] that payments made on or after January 1, 1951, by an employer to the widow or other beneficiary of a deceased officer or employee, in consideration of services rendered by the officer or employee, are taxable income to the recipient. If the payments are pensions and the recipient has not performed any services to the employer, the beneficiary is in receipt of a non-taxable gift.

Highway Use Tax—General Provisions

The 1951 legislature enacted a new tax law on trucks, tractors and trailers.[6] The purpose of the tax was to ease the financial burden of repairing damage done to the highways by the operation of heavy vehicles.

Every carrier must obtain a tax permit to use the highway for each vehicle which alone, or in combination with another vehicle, has a maximum gross weight of 18,001 or more pounds. A fee of $5.00 is payable for each separate trailer, tractor or truck for the permit.

On the 20th of each month a tax return is due covering the operations of the previous month. The tax rates are graduated by weight group and mileage covered during the month. For tractor trailers having a maximum gross weight between 18,001 and 20,000 pounds, the tax is six-tenths of one cent for each mile covered during the month. The rates go up progressively for each additional gross weight of 2,000 pounds to 2.4 cents per mile for a truck or tractor trailer having a maximum gross of more than 62,000 pounds. Only mileage in New York State is subject to the tax. The tax is

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4 January, 1951, pp. 49, 50.
5 Revision of July 9, 1951.
6 Article 21 of the Tax Law, Chapter 74, Laws of 1951.

on the person having the use or control of the motor vehicle, or the right to use or control. Both the owner and the carrier are jointly and severally liable for the tax.

Maximum gross weight is the controlling factor for each trip unless the vehicle was operated without any freight. Mileage of a vehicle operated exclusively within a Public Service Commercial Zone, a city, or a village is not subject to the tax. The Attorney General has recently ruled[7] that a motor vehicle is exempt from the tax if it operates exclusively within New York City where the starting point is located, but travels from New York City into New Jersey. No part of its *traffic* is upon the public highways of the State. The same exemption applies where the vehicle commences its operations outside the state but operates exclusively within the limits of a zone established by the Public Service Commission or the incorporated limits of a city or village.

The law applies to all vehicles having a gross weight of 18,001 pounds or more, whether they are registered in New York State or outside the State. The law requires all carriers to keep their records in New York State, but the Tax Commission upon application may consent to the keeping of records outside the State, provided New York's interests are fully protected.

The effective date of the law is October 1st, but the Tax Commission is advising truckers to file applications for permits by September 10th. A Truck Mileage Tax Bureau has been set up to service the issuance of permits.

Highway Use Tax—Computation

The tax is computed by multiplying the number of miles operated on New York public highways by the tax rate applicable for the appropriate weight group. If the vehicle is operated without any load, the tax is computed upon the gross weight of the vehicle based upon the mileage covered without cargo.

The maximum gross weight is the actual weight of the vehicle plus the weight of the load which the vehicle is capable of carrying. This weight may not be less than the manufacturer's rated capacity for the vehicle. This is applicable to trailers and tractors as well as trucks.

Official rules, regulations and instructions have already been issued by the Truck Mileage Tax Bureau in the form of questions and answers. Question 61 shows how the tax is computed for a vehicle that travels 300 miles with a load and 200 miles empty. If the maximum gross weight of the vehicle is 52,000 pounds the 300 miles will be taxed at the weight group tax rate of $.018 per mile or $5.40. For the 200 miles that the vehicle traveled empty it is taxed at its weight group rate of $.006 or $1.20. The total tax would be $6.60.

Question 62 cites the case of a motor vehicle having a maximum gross weight of 45,000 pounds and a weight of 16,000 pounds when empty. It travels 300 miles with a load, then travels 100 miles without any load, and then picks up a partial load for a distance of 200 miles. The 500 miles would be taxed at the weight group tax rate of $.015. There would be no tax on the 100 miles because the actual rate is less than 18,001 pounds when operated empty. The tax would thus be $7.50. Only motor vehicles having a maximum gross weight alone or in combination with any other vehicle in excess of 18,000 pounds are taxed.

Highway Use Tax—Permits

Separate permits must be obtained for each tractor or trailer, and permits must be obtained for motor vehicles registered in states other than New York. This provision applies also to vehicles engaged in interstate commerce and for vehicles exempt from the tax because they are operated exclusively within the incorporated limits of a city, a village, or within a com-

[7] Opinion of Attorney General, June 14, 1951.

mercial zone established by the Public Service Commission.

An application for a permit is filed on form TMT-1 with the Truck Mileage Tax Bureau, 1893 Broadway, Albany, N. Y. The application must be accompanied by a fee of $5.00 for each vehicle. This fee is payable only once and is not an annual charge. Ordinarily the owner of the vehicle applies for the permit. If the vehicle is leased for a period of more than 30 days the lessee obtains it. If an owner obtains a permit and thereafter leases the vehicle, the lessee also must obtain a permit.

With the permit, the owner or user of the vehicle receives a plate. The permit must be kept in the vehicle and the plate must be affixed at the rear of the truck near the registration plate. Permits and plates are not assignable.

Pennsylvania Excess Profits Tax Proposal

The Senate Finance Committee has reported favorably a bill to levy an excess profits tax on corporate incomes. For each taxable year ending after January 1, 1952, and beginning before January 1, 1955, a 5% tax would be levied on profits exceeding average monthly profits for the last 36 months in the calendar or fiscal year prior to January 1, 1952.

Sale of Personal Residence

The Tax Court recently decided the case[8] of a taxpayer who sold two residences during a taxable year, one at a gain and the other at a loss. The taxpayer sought to offset the loss against the gain on the ground that the capital gain section taxes the net long term capital gain which is defined as the excess of gains over losses. The Court held that since the loss is not deductible it does not qualify as a transaction that comes within the applicable offset provisions.

The result would be different under the State Income Tax Law which does recognize a loss on the sale of a residence.

Unincorporated Business Tax—Traders and Dealers

The Income Tax Bureau takes issue with our interpretation of the applicability of the unincorporated business tax to a partnership engaged in business as traders on their own behalf and also as brokers. In the July issue of the Tax Forum[9] we stated that only the income as dealers would be subject to the tax. The Income Tax Bureau calls our attention to Section 386 of Article 16A, which provides that the term unincorporated business does not include the purchase and sale of property for the account of the taxpayer only if that is the *sole* activity of the taxpayer. We respectfully take issue with the Income Tax Bureau.

An individual may be engaged in more than one activity. If the individual were both a trader and a dealer he would be subject to the unincorporated business tax on his activities as a dealer. *Only* the activity involving the purchase and sale of property for his own account would be excluded. A partnership, we submit, is in no different category from the individual. It is not an entity separate and apart from the individual partners, as a corporation would be. The unincorporated business tax is applicable to the taxable business income of an individual as well as a partnership. What Section 386 does, it seems to us, is to emphasize the fact that a partnership is generally subject to the unincorporated business tax, but that activities involving the purchase and sale of property for the account of the partnership are not subject to the tax, and *only (solely) those activities*, just as they would not be subject to the tax in the case of one individual taxpayer. To hold otherwise is to adopt an inconsistent position merely because two or more individuals are engaged in the activity as a partnership rather than one individual.

[8] *Richard P. Koehn* v. *Com'r.*, 16 T.C., 140165.

[9] Pp. 505-506.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

About a year ago one of the commissioners of the SEC, Mr. Edward T. McCormick, spoke at the annual meeting of the American Institute of Accountants. (Mr. McCormick subsequently resigned from the Commission to become president of the New York Curb Exchange, a position which he now holds.) The subject of his address was "Financial Statements—The Bridge Between Disclosure and Information," and it was one of the most stimulating talks on an accounting subject which we have read.

The Commission has been trying to simplify the prospectus which, under the law, is a document which must be handed to the buyer of a security. Some success in that direction has resulted from the continual review of the registration forms and requirements, but still the prospectuses in general use today are not as simple and brief as the SEC would like them to be.

The Commission's efforts at simplification have been directed principally at the non-financial (or text) portion of the prospectus, that is, the part which describes the business, the management and the securities. The Commission has been successful in simplifying the non-financial section of the prospectus, but, said Mr. McCormick, "we continue to cling blindly to tradition in the presentation of *financial* facts." According to him:

Louis H. Rappaport, C.P.A., has been a member of the Society since 1933. He is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A's., and is also a member of the American Institute of Accountants and of the American Accounting Association.

". . . while the Commission has made great strides in reforming the presentation of all other types of information it has rested content with the classical forms of balance sheet and income statement as the vehicles for disclosure in the prospectus. The strength of this tradition is revealed in the way we at the Commission have tended to refer to an example of a concise and readable prospectus. You may hear our staff describe such a prospectus as 'only 10 pages long, *exclusive of financials*' implying that simplification must stop at this ancient wall of convention surrounding the classical forms of balance sheet and income statement.

"But I think the time has come to ask ourselves how useful, really, is the traditional form of presentation to the lay investor? I wonder how many of you have ever tried to put yourselves in the position of an individual without financial or accounting training, set adrift on the sea of a formal balance sheet and income statement, and attempting to find his way through to some sort of adequate appraisal of the company's financial affairs. I know of one case where an intelligent school teacher, when she saw the balance sheet of a prosperous company became very dubious about the investment because, after observing that the total of assets equalled the total of liabilities, she concluded that the company 'Owes every penny it's got.' Unaware that it is only a convention that capital stock, reserves, and surplus are listed as liabilities, such an investor may well be baffled by the meaning of these accounts until they are explained.

"The income statement is likely to be more pertinent and informative. But, by itself, it still does not permit an adequate over-all appraisal of the company.

"We are so deep in the woods that we are in danger of seeing only the trees. The journals of our profession storm with disputes about accounting theory and the meaning and application of accounting concepts. But neither the profession nor, I must say, the Commission has as yet paid enough attention to the basic problem whether the usual *form* of presentation of accounting facts is a meaningful presentation to the untrained investor. The analyst who is accustomed to using financial statements accepts the traditional form of balance sheet and income statement as a matter of course. His trained eye directs

him to the pertinent parts of the statements containing the essential ingredients of his analysis. Because of his training he can relate the balance sheet, income statement and analysis of surplus in such a way as to enable him to make an appraisal.

"But I can well imagine many investors scanning the usual types of financial statements in despair, and giving up the search because of their lack of familiarity with the terminology and the basic conventions of accounting presentation. Yet, since the Securities Act was passed, millions of prospectuses have been printed and distributed to investors on the theory that the usual type of balance sheet and income statement serve the statutory end of informing the ordinary investor."

The speaker stressed that he was not talking about accounting concepts or principles; he was concerned with methods of presentation, with form rather than with principles.

"As I see them, the balance sheet, the income statement and surplus analysis are really an integrated presentation of the status of the enterprise. I am concerned with the fact that in disclosures to ordinary untrained investors convention continues to require the making of separate statements, often containing over-elaborate detail and in a form which is dictated by tradition rather than by its usefulness as an instrument of investor appraisal."

In the usual case a registration statement consists of two parts: (1) a prospectus which is delivered to the investor, and (2) an appendix containing certain other information which is filed with the SEC and available to the public, but is not given to investors as a matter of course. Mr. McCormick emphasized that the prospectus is not intended to be the repository of detail which might be significant to a sophisticated analyst in appraising investment values.

"That type of material, as well as material useful to the Commission in examining the statement, is contained in the appendix. These appendices are, of course, public information—and while they are not distributed to investors, they are frequently used by investing institutions, and by analysts and services in appraising registered issues . . . .

"I cannot believe that we lack the ingenuity to develop a means of furnishing to untrained investors the essential accounting information necessary to make a reasonable appraisal of the situation of any particular company. I do not think that we must remain wedded to the idea that the information must be presented in highly technical language and in the traditional form of a balance sheet, and an income statement set up in the conventional manner. I suggest we start from scratch and develop a technique for presenting this highly important information to the *layman* —to the man who cannot be expected to bring a technical background to the reading of financial statements."

He concluded his remarks by summarizing his proposal in three points:

"(1) I believe that we should abandon in the prospectus the formalistic presentation of financial data now in common use. (2) I believe that we should try to substitute for technical terminology in the prospectus simple and homely words to describe financial facts determined according to objecfive and uniform methods. (3) I think that we should eliminate unnecessary detail which is of limited usefulness to the ordinary investor and which serves only to encumber and obscure the financial story."

As a footnote to the above remarks it may be recalled that the SEC early this year circulated for comment a proposed revision of its principal registration form under the 1933 Act (Form S-1). The most significant changes were those relating to financial statements required to be included in the prospectus. It was proposed that the prospectus contain a summary of earnings together with a statement of financial position. All conventional balance sheets, income and surplus statements, and supporting schedules would be filed as part of the registration document but would not be included in the prospectus. At this writing it is not known whether the SEC intends to follow through on its proposal to revise Form S-1 along these lines.

Notes on the New York State Unemployment Insurance Law

Conducted by Samuel S. Ress

Some New Reporting Requirements

While the new Unemployment Insurance Law exempts most employers from filing detailed quarterly payroll reports on form IA 56 at the time that the Employer's report of Contributions (form IA 5) is filed with a remittance covering the contributions due for the quarter, the State requires the detailed reports on form IA 56 from those firms that have not been subject to the law for at least 3½ years prior to July 1st of any given year. This new quarterly report includes listing of each employee's social security account number, name, total number of weeks of employment and total remuneration for such weeks, total number of weeks of employment in which remuneration was less than $15, and total remuneration for such weeks during the quarter.

This report must be filed on or before the last day of the first month following the close of each calendar quarter. Section 581, subdivision c, of the Unemployment Insurance Law defines a "qualified employer" as one who may participate in " experience rating" and is exempt from the IA 56 report requirement.

His account must reflect his experience with respect to unemployment during not less than the fourteen calendar quarters immediately preceding July 1st of any year and he must have paid some remuneration in the calendar year immediately preceding July 1st, and filed all contribution reports for that calendar year.

The penalty for failure to file form IA 56 within 20 days after the demand for the filing of this report amounts to $3.00 for each employee not reported, but not to exceed $500.00 or 3 percent of the remuneration paid to such employees, whichever is less. Under certain circumstances the joint experience of predecessor and new firms may be combined so as to qualify a new employer.

In this connection the writer has received rulings from the Unemployment Insurance Division in four different cases which may be helpful to practitioners in advising clients as to whether or not they may participate in "experience rating" or be required to file the detailed IA 56 reports because of their insufficient "age".

Case No. 1: On or about January 1st, 1950, a new corporation, purchased

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Dr. Ress, who has written a number of articles which have appeared in *The New York Certified Public Accountant*, is a member of the Society's Committees on Clothing Manufacturing Accounting and on Labor and Management.

from C, an individual proprietor, all of his machinery and equipment, business and accounts, and also continued to employ substantially all of the former employees of C who discontinued business at the time of the sale, after having been in business for over 3 years. The Unemployment Insurance Bureau ruled that the new corporation is a qualified employer and that, considering the experience of the predecessor, liability had existed for at least three and one-half years prior to July 1, 1951. Accordingly the new corporation is not required to file the IA 56 reports.

Case No. 2: A two-man partnership (No. 1) became an employer subject to the Unemployment Insurance Law in the first quarter of 1942. Another two-man partnership (No. 2), operated a similar business. Both two-man partnerships discontinued business in the third quarter of 1950 and were succeeded by a new four-man partnership (No. 3), which acquired all or substantially all of the assets of partnerships Nos. 1 and 2.

On December 31, 1950, partnership No. 3 dissolved and partnership No. 2 resumed business on January 1, 1951, with its two original partners and its original machinery, equipment and employees. Partnership No. 1 also resumed business on the same date with its two original partners and its original machinery, equipment, and employees.

The Bureau held that since neither of the two-man partnerships acquired all or substantially all of the assets of the four-man partnership to which they had originally transferred their assets, the experience of the four-man partnership may not be considered with the experience of either of the successor two-man partnerships. Accordingly, since liability had not existed for a least 3½ years prior to July 1, 1951, for each of the two-man partnerships, quarterly reports on form IA 56 had to be filed.

Case No. 3: A and B were a partnership. The partnership operated two plants, one in The Bronx and one in Queens. The partnership discontinued operations at the Bronx plant on November 28, 1948, and continued operations at the Queens plant until December 31, 1948. B, one of the former partners in the firm acquired the assets of the Bronx plant on December 3, 1948. A acquired the assets of the Queens plant on January 1, 1949. The Bureau held that since A had acquired all of the remaining assets of the partnership after it had discontinued all operations on December 31, 1948, he succeeds to the experience of the partnership and that by including the experience of the partnership, liability existed for at least 3½ years prior to July 1, 1951, and A is not required to file quarterly payroll reports.

However, they held that B, the former partner who had acquired the Bronx plant on December 3, 1948, could not be deemed the successor of the preceding partnership because at the time that he acquired the plant, the partnership still retained other assets, viz., the Queens plant which was not disposed of until January 1, 1949, when the former partner, A, acquired it.

It was held, therefore, that since B could not be deemed a successor to the predecessor partnership, he is required to file quarterly payroll reports on form IA 56.

Case No. 4: A. S., an individual employer, became liable under the Unemployment Insurance Law on January 1, 1936, and continued until the third quarter of 1949, when he was succeeded by the S & S Co., a partnership consisting of A.S. & B.S. Later on, during the same third quarter of 1949, the S & S Co. was again succeeded by A.S., who resumed business. There were other changes in the ownership of the business during the period running from the first quarter of 1950 through the first quarter of 1951. The Unemployment Insurance Division had been informed that with each change the successor entity acquired the assets of the predecessor entity; however, the Division was not informed whether the S &

S Co. partnership had acquired the assets of A.S. when he discontinued business in the third quarter of 1949.

They held, therefore, that the previous experience of this employer cannot be considered, and that the only period of experience that can be considered is that from August 31, 1949, to the date on which the partnership between A.S. & B.S. began business, even though A.S., the individual operating the business today is the same A.S. who had been liable for and paid contributions under the N. Y. State Unemployment Insurance Law from January 1, 1936, until the third quarter of 1949, a period of thirteen years. The State indicated however that it would consider the previous experience of A.S. if information was received that the partnership had acquired all or substantially all of his assets after he discontinued operations on August 31, 1949, indicating the date of acquisition of such assets.

Seasonal Payroll Reports

Another important reporting form that the Unemployment Insurance Division requires under the new law is known as IA 56.2, which is a seasonal payroll report. Each employer who conducts a seasonal business is required to make arrangements to supply on request individual wage records, covering the entire season during which the business was operating, at the time of the shut-down or at any time during the previous 52 weeks, or to submit at the time of the shut-down a seasonal payroll report containing information covering the entire period during which the business was operative.

This report must be submitted to the Unemployment Insurance Division within five days after the seasonal business is closed. The information required for each employee includes the social security account number, name of employee, total number of weeks employed, total remuneration, total number of weeks in which remuneration was less than $15.00 per week, and total remuneration for such weeks.

A third special individual employee payroll report must be filed on form IA 56.3 by any employer who discontinues business. Each employer who discontinues business is required to file a report for each employee who was on his payroll during the 52-week period preceding the week during which the employer ceased business and during the week in which the business ceased. The report must show the date on which the business ceased, the employee's name and social security account number, the week ending date, and remuneration paid to the employee during each week of the 53-week period. The form must also show the employer's registration number and name of firm, signature title, and date of mailing to the Division. It must be filed within five days after the business ceased.

The law provides that if any firm goes out of business and fails to file this detailed report for each of his individual employees within 20 days after the mailing or personal delivery of a demand for such special report by the Industrial Commissioner, such defaulting employer shall be required to pay a $10.00 penalty with respect to each employee not reported by him in compliance with such demand.

However, an employer who goes out of business may be relieved of this very burdensome requirement to file IA 56.3 reports detailing each individual employee's earnings week by week for a whole year, if he can satisfy the Industrial Commissioner that at the time he goes out of business he has made adequate provision for furnishing the information required by the Industrial Commissioner for the determination of a claimant's benefit rights.

Each employer who goes out of business should therefore arrange with his accountant, or any other duly authorized person with whom he has left his payroll records, to answer within seven days from the date of mailing, the employment and wage data required on form LO 12.9 by the New York State Unemployment Insurance Division for

a period of at least one year following the date when the firm goes out of business.

Form LO 12.9 is a regular report required to be filed by all employers whose former employees apply for Unemployment Insurance benefits. It should be borne in mind that failure to reply on form LO 12.9, Request for Employment and Wage Data, within seven days of the date of mailing, may subject the employer to a $10.00 penalty.

Another important term that must be kept in mind with regard to all the Unemployment Insurance wage reports that must be submitted in connection with Unemployment Insurance benefit claims by former employees is that the term "week" means the seven-day period commencing Monday and ending on Sunday.

Security for the Professions

Attorney General Nathaniel L. Goldstein recently wrote an article entitled, "Security for the Professions," which appeared in the June, 1951, issue of the Journal of the American Bar Association. He speaks on behalf of the professional practitioner "who is truly forgotten by the tax laws and who stands in a position completely exposed to the destructive effect of high and yet to be higher surtaxes upon his ability to secure his old age." Mr. Goldstein's proposal, which followed his careful analysis of the problem, is presented below and deserves the careful study and consideration of all professional people.

"The proposal, therefore, is that the law particularly permit those who earn their income by personal practice of the professions to project a limited portion of their earnings to the future so that they may escape the full impact of the surtax on peak earnings and enable them thus to establish a secured fund for retirement. This would be accomplished by an extremely simple and easily administered plan requiring investment in special Government bonds and deferring the tax upon the amount thus invested until redemption of the bonds. The basic features of such a plan would be these:

(1) Allow the taxpayer to exclude from gross income in any taxable year prior to attaining age 65 an amount invested in special United States Government bonds.

(2) Limit the amount which may be so invested in any one year to $10,000 or 15% of earned net income in the practice of his profession, whichever is less.

(3) Provide that the bonds shall be nonnegotiable, nonassignable and shall not bear interest.

(4) Permit the bonds to be redeemed only upon attainment of age 65 and at any time during the life of the taxpayer thereafter or at death.

(5) In the event of death, either before or after age 65, permit the bonds to be redeemed by the estate within a period limited to 5 years.

(6) Require inclusion of the proceeds of the bonds in the gross income of the taxpayer or of his estate, as the case may be when redeemed, and exclude such bonds unredeemed at death from the estate tax.

"Such a plan would seem to present few administrative difficulties and would insure collection of the tax upon the deferred income. It would permit the professional earned income taxpayer to avoid the unfairly onerous effect of high surtaxes upon him by a method which will automatically average out his income within limitations effectuating the primary purpose of enabling professional men to achieve the measure of security now denied or the impact of such surtaxes. Administrative cost should be small and no interest burden will be placed upon the Treasury. The only loss of revenue will be that arising from the difference between the high surtaxes upon the limited income which may be thus deferred and the tax upon the net income at the time the savings are drawn down and during the period of deferment of tax the Government will have the use of the monies without cost."

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Preparing for the "Tax Season"

It is not too early to start planning and organizing for the tax season that will soon arrive. The preparation of tax returns is a field in which attention to methods used should yield substantial savings in time and cost, and reduce errors and embarrassments to a reasonable minimum.

Each year the experiences of the prior year should be reviewed for the new ideas that were developed and which should be put into effect. Moreover, changed tax return requirements must be studied to develop the methods of compliance.

The tax department, permanent or temporary, must have some of the elements of a "factory" operation to turn out hundreds, or thousands, of returns in a period of about two months. It should also be as efficient as possible, and have as fine a system as the accountant could install for any client.

Time-saving ideas for the tax department have been publicized much less than for the auditing operation. The following articles in *The New York Certified Public Accountant* will be valuable to accountants who are interested in the subject.

1. Office Procedures for Controlling the Processing and Filing of Income Tax Returns—January, 1949.
2. Some Hints with Respect to the Assembly of Tax Information and the Preparation of Tax Returns—January, 1949.
3. Avoidance of Year-End Deluge by Planned Administration of the Accounting Practice — September, 1951.

The actual physical aspects of the tax department's activity have not received much consideration from writers. Yet some of the bottlenecks and mass activity are in this area of operation. Accordingly, the following ideas on the handling of returns—apart from preparation—have been gathered, and are submitted here in sketchy, suggestive form due to the size of the subject.

To the extent that facilities permit, avoid crowding too many men into a room. Crowding is responsible for loss of time and errors. Plan now how to rearrange the office, if necessary, to create the best working conditions.

Have supplies of returns and working paper available at convenient points. Keep track of the number of blank returns on hand daily to avoid running out of them. Establish a procurement squad that will be responsible for obtaining blanks. Since forms are not always easily obtainable, the procurement problem is not to be treated lightly.

Establish definite procedures for the removal of tax folders from the files and also for the removal and insertion of papers. Where hundreds of folders are involved, each operation is time consuming. One step saved means much time saved and a reduction in overtime and overwork.

Provide baskets, or other receptacles, to hold folders and returns which are "in process." These receptacles should have large placards to indicate their use and they should be placed in a convenient place to avoid excessive moving about by men. To illustrate, receptacles should be provided for returns which are to be prepared, to be reviewed, to be typed, to be proofread, held for additional data, and for such other purposes as are required in the individual case.

Some accounting firms move the returns from process to process together with the related folder and tax return control card or other form. The return and schedules are kept outside of the folder, attached by rubber bands or clips, to avoid removing and returning papers to the file any more times than absolutely necessary.

Where state returns are prepared simultaneously, or shortly afterwards, the methods of handling returns and supporting schedules, particularly such data as is prepared in a number of copies for use in more than one return, may be organized so as to require minimum handling and be conveniently located.

Putting a return together, that is, attaching the supporting data to the return, folding the return for insertion in the mailing envelope, addressing, sealing, and stamping the envelope, all of these are procedures which can be standardized and made highly efficient by the procedures established and office equipment used. This work should be assigned to one who is familiar with what must be attached to a return, to insure proper final disposition.

A variety of forms are utilized by accounting firms to control procedures, provide check lists for certain functions, serve as worksheet and schedule dummies, federal and state tax reconciliation forms (personal income tax returns), instruction letters to clients, and for other individual purposes.

Follow-up forms, such as those noted below, are helpful in insuring that nothing is overlooked. They are prepared as soon as their need is recognized.

Form for carryback refund claims to be prepared.

Form for distributive shares of members of partnerships and of beneficiaries on fiduciary returns.

The use of tax calculation charts is a tremendous time saver in the preparation and review of returns. However, charts must be selected with care and their limitations, if any, fully understood. There should be no stinting on the number of charts available as it is annoying and wasteful of time for men to have to hunt for a chart whenever needed.

* * *

Suggestions as to time-saving ideas for the tax department are solicited. Useful forms are also welcome. Such material should be promptly submitted for timely publication. Mail them to The Editor, Office and Staff Management, at the Society's office.

* * *

A specimen form of tax return instruction sheet, which provides standard instructions to clients as to completion and disposition of tax returns, is reproduced. Such forms may be mimeographed, printed, or otherwise prepared, and can be utilized for every return that is prepared in sufficient numbers to warrant a form letter. (Exhibit 1).

There is also reproduced a form reconciling Federal and New York State personal net income. This is a great time-saver form which is also useful as a proof of the accuracy of both returns. (Exhibit 2).

EXHIBIT 1

ACCOUNTANT'S LETTERHEAD

Federal Corporation Income Tax Return

Instructions for Filing

NAME OF TAXPAYER:	....
WHEN DUE:	On or before ....
TAX DUE:	$...................... should be paid to the Collector of Internal Revenue either in full or as follows: On or before........................... $.................... On or before........................... $.................... On or before........................... $.................... On or before........................... $....................
SIGNATURES REQUIRED:	The return should be signed at the bottom of page one by two officers, as follows: 1. President or other principal officer (State title) 2. Treasurer, Ass't. Treasurer, or Chief Accounting Officer (State title) Notarization is not required but the corporate seal must be affixed to the return.
MAILING INSTRUCTIONS:	The return and remittance, if any, should be mailed to the Collector of Internal Revenue, ... If a receipt is desired covering the mailing, request registered mail—return receipt.

We shall be glad to furnish any additional information desired with respect to the attached return.

....

(Date)

Accountant's Name

EXHIBIT 2

RECONCILIATION OF FEDERAL NET INCOME WITH NEW YORK NET INCOME

TAXPAYER: .... YEAR: ....

Net income, per line 3, page 3 of Federal return .... $..........................

Add: New York State income tax ....

Net capital loss ....

Adjustment for contributions ....

Increase in partnership income reportable to N. Y. ....

Capital gain dividends (Investment trusts, etc.) ....

....

....

Total ....

Less: Life Insurance premiums* ....

Net capital gain ....

Interest on U. S. obligations ....

Federal excise taxes ....

**Adjustment for medical expenses:

Per State $..........................

Per Fed. ....

....

....

Total Reductions ....

Net income per New York State return: $..........................

Per husband's return..... $..........................

Per wife's return......... ....

Total as above.............. $..........................

* On a joint return, deduction may be claimed for premiums paid on the life of each spouse up to a maximum of $150.00 for each (total $300).

** On New York State return, maximum medical deduction is $750.00; $1,500.00 for head of family or husband and wife filing joint return.

The Excess Profits Tax Exchange

Conducted by DAVID ZACK, C.P.A

THIS column is a clearing house for questions, problems and comments regarding Excess Profits Taxes. Items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified Public Accountant
677 Fifth Avenue
New York 22, N. Y.

Application for Relief by New Corporations

Carl W. Brown, C.P.A., submits the following interesting question:

> Sec. 445 defines "new corporations" and introduces a special method for computing average base period net income for such corporations.
>
> Sec. 447(e) states that such benefits are available only if a timely application is filed "setting forth the grounds for the application of such section in such detail and in such manner as the Secretary may prescribe." It further states, "Section 445 shall not be applied upon the basis of any grounds other than those set forth in an application filed within the period prescribed in such subsection."
>
> Sec. 40.447-3 of Reg. 130 says "The application, however filed, must include a statement setting forth in detail each ground upon which the taxpayer relies, and facts sufficient to appraise the Commissioner of the exact basis for the application. Section . . . 445 . . . shall not be applied upon the basis of any ground other than those set forth in an application filed within the period prescribed in section 447(e)."
>
> The introduction to 1950 Schedule EP (form 1120) states the same thing under Schedule EP-5-General Instructions.
>
> Nowhere is there any indication of what "grounds" the statute or the Commissioner has in mind. If the requirements of Sec. 445 are met, and the application of this section results in a higher credit than that of any other section, the "grounds" for a taxpayer to apply for application of Sec. 445 would seem sufficient. But the taxpayer seems to be called upon to be a legislator and to find grounds upon which the application of Sec. 445 would not only be practical for him, but also justified and equitable from a general point of view. And he must do a thorough job, because he cannot change or supplement his "grounds" later on.
>
> I do not wish to criticize this kind of buck-passing legislation—the statute says nothing, the Commissioner says nothing, the taxpayer must make up the law himself—but would merely like to know: what are the grounds which could reasonably be expected to justify an application for the benefits of section 445, other than meeting the requirements of that section and gaining advantage from its application?

Section 447 (e) of the Internal Revenue Code is a procedural section which encompasses the relief provisions of Sections 442, 443, 444 and 446, as well as Section 445 which deals with "new

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DAVID ZACK, C.P.A., is a member of our Society and of its Committee on Federal Taxation. He is Chairman of the Committee on Municipal and Local Taxation.

Mr. Zack is a member of the New York Bar, the Federal Bar, and the Tax Bar. He is a Lecturer on Taxation at The City College (N. Y.) School of Business and Civic Administration where he developed an intensive course on the New Excess Profits Tax Act.

Mr. Zack has written on tax matters for various publications. He is engaged in tax practice with a prominent New York firm of certified public accountants.

NOTE: Any answers to questions contained herein represent the opinions of the author and are not promulgations by the Society.

corporations". The general language in Regulations 130, Section 40.447-3 is also applicable to all of the general relief provisions included in Sections 442, 443, 444, 445 and 446 of the Code. The so-called "grounds" for relief are much more subjective and intangible in those other relief sections, namely: Section 442—Abnormalities during the base period, Section 443—Change in product or services, Section 444—Increase in capacity for production or operation, and Section 446—Depressed industry sub groups. The reader's difficulty therefore stems from the all-inclusive nature of Section 447 (e) which attempts to prescribe a single procedural pattern for all the general relief sections. Actually, the application for relief under Section 445 should be the simplest to prepare as the "grounds" are quite objective. The statute would seem to indicate the following requirements, which must exist concurrently, for qualification under Section 445:

(1) The corporation must have commenced business after the first day of its base period; and

(2) The taxpayer must not be an ineligible corporation.

These grounds appear to be quite objective, especially inasmuch as Section 40.445-1 of Regulations 130 specifically defines the phrases "commenced business" and "ineligible corporations". Sections 461 (c) and 462 (g) set forth the rules to be applied in the case of component and acquiring corporations. The taxpayer then would merely have to state the facts under each of these headings.

Check-list of Elections

Now that the extension dates for the filing of the first excess profits tax schedules are running out, despite the recent enactment of H.R. 4014 which permits extensions until November 15, 1951, it might be helpful to list the major choices which the practitioner must consider in the preparation of the form.

(1) Interest adjustment on borrowed capital (Section 433 (a) (1) (N) and (O))

(2) Net Operating Loss *v.* Base Period Loss Adjustment (Section 433 (a) (1) (J))

(3) Instalment Basis Taxpayers —instalment or accrual basis (Section 455).

(4) Long Term Contract Taxpayers—(Section 455).

(5) Abnormal Income — irrevocable election of class (Section 456 (2)).

(6) Alternative Excess Profits Tax Credits.

(a) Average Earnings Method —Section 435.

1. Abnormal deductions — Section 433 (b) (9) and (10).

(b) Invested Capital Method

1. Asset Method—Section Section 437.
2. Historical Method— Section 458.

(c) Minimum Credit—Section 431.

(d) Railroad lessor-lessee corporation—Section 434 (d).

(e) Regulated public utility— Section 448.

(f) Corporations engaged in mining of strategic materials— Section 450.

(g) Mining, timber and natural gas operations—Section 453.

(h) Contracts under Merchant Marine Act of 1936—Section 457.

(i) Growth Corporations—Section 435 (e).

(j) Corporations with production interrupted or income depressed during base period because of unusual events or temporary economic circumstances—Section 442.

(k) Corporations which made a substantial change in products or services—Section 443.

(l) Corporations which in-

creased productive capacity—Section 444.

(m) New corporations — Section 445.

(n) Corporations which were members of a depressed industry sub-group—Section 446.

(o) Acquiring and component corporations — Part II and Part III.

(7) Capitalization of Advertising and Goodwill Expenditures — Section 451.

(8) Adjustment for Inconsistent Position—Section 452.

(9) Consolidated corporations—Section 141.

(10) Exempt Corporations—Section 454.

(11) Personal Service Corporations—Section 449.

The check-list set forth above does not pretend to be all-inclusive and this column would welcome any additional listings. No attempt has been made herein to indicate which option is a mere alternative and which represents a truly irrevocable election. The list is intended merely as a guide to the practitioner in his excess profits tax thinking. It must also be remembered that many of these choices are interdependent and may vitally affect the client's tax future. In the case of excess profits taxes, the phrase "Let the buyer beware" may well be replaced by the maxim—"Let the taxpayer (or practitioner) beware".

OFFICIAL DECISIONS *and* RELEASES

The following revisions, bringing Sections 25, 91 and 92 of the Commissioner's Regulations up to date, were recently received from Mr. John R. Wilkinson, the Executive Secretary of the New York State Board of CPA Examiners:

REVISIONS OF THE REGULATIONS OF THE COMMISSIONER OF EDUCATION GOVERNING HIGHER AND PROFESSIONAL EDUCATION

ARTICLE XI

CERTIFIED PUBLIC ACCOUNTANCY

§ 25 Notwithstanding the provisions of the following sections relating to the filing of applications for admission to professional examinations, any person who has been admitted to an examination and seeks readmission to a subsequent examination or part thereof in the same profession, shall file an application for admission to said professional licensing examination not less than ten days before the examination. The Assistant Commissioner for Professional Education may, in his discretion, waive the requirements of both the aforegoing sentence and the following sections of these Regulations relating to the time requirement for filing applications for admission to the professional licensing examinations upon proof being submitted that the person making application has been duly registered for military service under the Selective Service Act and has been notified to appear for induction into said military service.

§ 91 **Professional requirements**

1 Candidates for the certified public accountant certificate who have completed their course of study in a college or school of accountancy registered by the Department as maintaining a satisfactory standard, or its equivalent as determined by the Commissioner, shall be entitled to admission to the examination in theory of accounts and in commercial law.

2 Candidates who complete three years of diversified accounting experience satisfactory to the State Board of Certified Public Accountant Examiners, subject to review by the Commissioner of Education, shall be entitled to admission to the examination in auditing and in practical accounting. Diversified accounting experience to be considered satisfactory shall be such as to have required the intensive application of accounting principles and auditing procedures in the public practice of accountancy. The State Board of Certified Public Accountant Examiners shall accept Service in the armed services of the United States during World War II on the basis of one month's credit for each six months' service with a maximum credit of eight months. [As amended July 21, 1950 and February 15, 1951]

3 [*No change*]

§ 92 **Other requirements**

1 [*No change*]

2 [*No change*]

3 Each application must be accompanied by a recent photograph approximately two by three inches in size and by a fee of $25, which fee shall entitle the candidate to two complete examinations. Examinations in two or more subjects are considered a "complete" examination. No fee is required of a candidate who is scheduled by the Department for a single subject only. A candidate who passes two subjects in any one examination shall not be re-examined in such subjects. However, a candidate who passes the subject of practical accounting or auditing shall not be re-examined in that subject. Any candidate who has failed any subject in four successive examinations shall not be eligible for admission to any subject in the two succeeding examinations.

4 [*No change*]

5 An application for admission to the examination in theory of accounts and in commercial law shall be filed with the Department not less than 30 days prior to the date of the examination; an application for admission to the examination in practical accounting or in auditing shall be filed with the Department not less than 90 days prior to the date of the examination. Any false or misleading information in connection with any application may be cause for exclusion from the examinations on the ground of lack of good moral character. If the Department finds that the application is complete and that all of the requirements have been met, it shall issue to the applicant an admission card which shall advise him of the time, date and place of the examination. When the candidate submits each examination paper he shall exhibit his admission card to the examiner. At the conclusion of the final examination the examiner shall retain the card.

6 [*No change*]

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